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ENERGY LITIGATION UPDATE 2016

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I. Non-Operator v. Operator and Other Oil and Gas Operations-Related Cases

A. Court resolves dispute over interpretation of Participation Agreement, with a preprinted AAPL Model Form Operating Agreement attached as an exhibit, regarding which party was entitled under the contract to be the Operator of the wells.

The recent decision in *U.S. Energy Development Corp. v. Stephens Energy Group, LLC*,[1] arose out of a Participation Agreement (PA) entered into in April 2011 by Slawson Exploration Company, Inc., U.S. Energy Development Corporation and Osage Exploration and Development, Inc. covering a project area or field of oil and gas leases and wells. A number of third party working interest owners held interests of varying sizes in those wells, but those other owners did not sign, and were not subject to, the PA that had only been agreed to by the aforementioned three substantial owners in the project area.

As between the three parties to the PA, their respective approximate interests in the properties covered by the PA was: Slawson – 45%; U.S. Energy - 30%; and Osage – 25%. The PA provided that Slawson would be the operator of all wells. Attached as an exhibit to the PA was an unsigned AAPL Model Form 610 – 1989 Operating Agreement. The PA provided that "[w]here there is a conflict between the Operating Agreement and [the PA, the PA] will control." The PA also recognized the right of each of the parties to "assign their rights, duties, and obligations hereunder, so long as any assignment by a Party hereto is expressly made subject to the terms and conditions herein contained."[2] The preprinted form Operating Agreement attached as an exhibit to the PA named Slawson as Operator, in accordance with the express provision of the PA. The Operating Agreement also included provisions for the Operator's resignation or removal, and for the selection of a successor Operator.

Slawson had also been named as the Operator of some 30 wells under Oklahoma Corporation Commission force pooling orders which, in Oklahoma, provide a separate source of operator rights, apart from any private contract such as the Participation Agreement at issue in this case, or a stand-alone Operating Agreement. The Commission's pooling order was

1. No. 15-6188, 2016 WL 5210888 (10th Cir. Sep. 21, 2016) (Petition for Rehearing pending as of the time this paper was submitted for distribution). The District Court decision that was reversed by the 10th Circuit Court of Appeals may be found at No. CIV-14-1319-C, 2015 WL 5031920 (W.D. Okla. Aug. 25, 2015).

2. *U.S. Energy Development*, 2016 WL 5210888 at *1.

effective as to the working interest owners in the subject wells who were not parties to the PA.

In July 2014, Slawson entered into a Purchase and Sale Agreement (PSA) under which it sold most of its rights, titles and interests in the project area to Stephens. Slawson agreed to transfer possession and physical operation of the assigned properties to Stephens as part of the closing, but did not warrant that operations could be transferred to Stephens. The PSA provided that "transfers of operations will be subject to all necessary regulatory and third-party approvals" and that Slawson would "use its commercially reasonable efforts to assist [Stephens] in becoming successor operator."[3] Slawson subsequently delivered to Stephens assignments of its working interest in the subject units and wells, and filed the appropriate form with the Oklahoma Corporation Commission showing that it was transferring well operations to Stephens. Stephens promptly filed applications with the Commission to be named the successor operator under the Commissions prior force pooling orders.

Relying on the provisions of the Operating Agreement exhibit to the PA, rather than the above-referenced assignability clause of the PA, Osage asserted that Slawson and resigned as operator under the PA and had also ceased to be operator under the PA by virtue of assigning all of its working interest rights in the lands covered by the PA to Stephens. Osage and U.S. Energy conducted a purported new operator election and voted Osage as the successor operator under the PA.

Stephens, denied the position of Osage and U.S. Energy and asserted that the express wording in the PA that gave Slawson the right to operate all wells under the PA, and to assign its rights under the PA to another party (Stephens in this instance), controlled over the conflicting provisions of the Operating Agreement exhibit that were cited by Osage.

Osage and U.S. Energy then sued Stephens for a judicial declaration that Osage was the valid successor operator and enjoining Stephens from continuing to possess the wells under its claim of operatorship under the provisions of the three-party PA (with the Commission having not yet decided who should be the successor operator under the Commission's pooling orders). The District Court found that the operator election and succession provisions of the Operating Agreement attached as an exhibit to the PA were controlling and found that Osage was the valid successor operator to Slawson under the PA. Stephens appealed.

3. *Id.* at *2.

The 10th Circuit Court of Appeals reversed the judgment of the District Court. The 10th Circuit found that "Oklahoma law presumes that contractual rights and duties are assignable, unless the parties provide otherwise in their agreement, or unless the duty is so specialized that the identity of the performing party is material to the contract."[4] The court found that Osage and U.S. Energy failed to show that either exception applied here. The court also rejected the appellees' assertion that the term "Operator" has a special meaning in the oil and gas industry that excludes it from the general presumption that contractual rights and duties are freely assignable.[5]

B. "Frac hit" lawsuit brought by Operator of well allegedly damaged by the frac job conducted on a neighboring horizontal well was dismissed on grounds of improper venue.

In *A. B. Still Wel-Service, Inc. v. Antinum Midcon I, LLC*,[6] the operator of a vertical well sued the operator and non-operators of the nearby Eggers horizontal well. The plaintiff Still alleged that the frac job conducted on the Eggers well caused damage to the Still's well. The plaintiff asserted claims for alleged negligence, trespass, nuisance, conversion of hydrocarbons and unjust enrichment. The lawsuit was filed in the county where the plaintiff corporation was located. The trial granted the defendants' motion to dismiss due to improper venue, finding that this suit was an action for "damages to land, crops or improvements thereon" within the meaning of 12 O.S. § 131(2), and that the lawsuit must instead be filed in the county where the plaintiff's land and well were located. The plaintiff appealed.

The Oklahoma Court of Appeals affirmed. It found that the present action alleged damage to land, that the related claims of injury to contractual rights and loss of production depended upon whether plaintiff could show that the defendants damaged the land, and that this suit was properly dismissed pursuant to Section 131(2).

C. Court addresses claims against the Railroad Commission for negligence and breach of contract for mistakenly plugging an abandoned offshore well that the Commission had agreed to postpone plugging.

In *Railroad Commission of Texas v. Gulf Energy Exploration Corporation*,[7] the Commission had issued orders requiring American

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4. *Id*. at *5.
5. *Id*. at *6.
6. ___ P.3d ___ (Okla. App. 2015 - #113755) (For Publication) (Petition for Certiorari Pending at the time of the submission of this paper).
7. 482 S.W.3d 559 (Tex. 2016).

Coastal Enterprises (ACE) to plug a number of inactive offshore wells the company operated in the Gulf of Mexico. ACE did not have sufficient assets to carry out the orders, and the company declared bankruptcy in May 2008. So, the Commission took over the plugging responsibility. On April 24, 2008, the Commission awarded Superior Energy Services a contract to plug 8 of the ACE wells, including the two wells at issue in this case identified as the 707S-5 and 708S-5 wells.

However, at the time the plugging order issued, Gulf Energy Exploration Corporation was the lessee of the offshore area that included the 708S-5 well, having acquired the lease from the General Land Office in 2007. On May 19, 2008, representatives of Gulf Energy, ACE and the Railroad Commission met and reached an oral agreement that the Commission would delay plugging 4 of the remaining wells covered by the plugging order, including the 708S-5. A formal settlement agreement was signed by the Commission on June 6, 2008. The bankruptcy court approved the settlement.

In September 2008, the Commission issued several orders superseding the plugging orders on the wells covered by the Settlement Agreement and approving Gulf Energy's request for a transfer of operations.

A few months later, Gulf Energy discovered that the 708S-5 well had been plugged. In fact, it was determined that the well had been plugged on May 25, 2008, under the mistaken belief that the well being plugged was instead the 707S-5 well. The mistake originated with an admitted clerical error by Commission staff who inadvertently transposed the coordinates for the locations of several wells, resulting in the 708S-5's aerial photograph and coordinates being labeled as those of the 707S-5 well, and vice versa. The mislabeled data was provided to the contractor hired to plug the wells.

After discovering that the 708S-5 well had been mistakenly plugged, Gulf Energy sought and obtained permission from the legislature to sue the Railroad Commission for no more than $2.5 million in damages. The legislative consent and resolution did not waive the Commission's immunity from liability, nor did it waive any defense of law or fact except for the defense of immunity from suit without legislative permission.

Gulf Energy asserted negligence and breach of contract claims against the Commission and Superior, the contractor that plugged the well. Gulf included assertions that the crew members, including a Railroad Commission representative on board, ignored obvious indicators that they were at the wrong well when they mistakenly plugged the 708S-5 well. All claims were submitted to the jury. Superior settled with Gulf while the jury was deliberating.

The jury found that the Commission failed to comply with its agreement to postpone the plugging and abandonment of the 708S-5 well and that the Commission's negligence proximately caused Gulf Energy's damages. On the negligence claim, the jury attributed 65% of the responsibility to Superior and 35% to the Commission. The Commission appealed. The Texas Court of Appeals affirmed.[8]

The Texas Supreme Court reversed.[9] In reversing the judgment in favor of Gulf Energy, the Texas Supreme Court engaged in a detailed analysis that focused in primary part on two key issues. First, the court found that the trial court erred in the failure to include in the jury charge a question on the "good faith" defense of the Commission under Natural Resources Code section 89.045.[10]

Second, the court found that the trial court erred in failing to include in the jury charge a question on contract formation, based on the Commission's assertion that a fact issue existed on whether the parties had reached a meeting of the minds on the date (May 25, 2008) when the contract was alleged to have been breached by the plugging of the well.[11] The trial court overruled the Commission's objection to the omission of that issue in the jury charge and ruled that a contract between the Commission and Gulf Energy was formed as a matter of law before the well was plugged. The trial court, in effect, held that the parties had a binding contract when they reached the oral agreement at the meeting on May 19, 2008, and not when they signed the written Settlement Agreement three weeks later on June 9, after the well was plugged.

The judgment below was reversed and the case was remanded for a new trial.[12]

II. Royalty Owner Litigation

A. Pending Oklahoma appeal might significantly clarify the status of Oklahoma gas royalty law regarding the scope of post-wellhead expenses that may be factored into royalty payments.

In the original appeal in *Pummill v. Hancock Exploration LLC*,[13] the defendants sought to reverse the District Court's entry of some 40 pages of

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8. *R.R. Comm'n of Tex. v. Gulf Energy Expl. Corp.*, 480 S.W.3d 570 (Tex. App. 2014).
9. *R.R. Comm'n of Tex. v. Gulf Energy Expl. Corp.*, 482 S.W.3d 559, 576 (Tex. 2016).
10. *Id.* at 575-76.
11. *Id.* at 572-76.
12. *Id.* at 576.
13. No. 111,096, Oklahoma Supreme Court (appeal initiated September 27, 2012).

orders granting summary judgment in favor of the Pummill plaintiffs on certain issues associated with the allegations of improper deductions and royalty underpayments. The Oklahoma Supreme Court, in assessing whether to grant certiorari review with regard to the Court of Appeals' affirmation of the summary judgment rulings, described the 3 key summary judgment issues as follows:

> "Issue 1: The express language of their leases does not abrogate or negate the implied covenant to market in any way;
>
> "Issue 2: The current or future use of POP [Percentage of Proceeds], POI [Percentage of Index] or any other form of contract, instead of a fee based agreement with Enogex, does not change the amount of royalties due under the leases;
>
> "Issue 3: Appellants are entitled to receive royalties on gas used off the lease or in the manufacture of products at the gas plant.[14]

As to those three issues, the Court found that "facts which could affect the resolution of [Issues 1, 2 and 3 that] need to be addressed before the fact-finder, the district court." As a result, the Supreme Court reversed the opinion of the Court of Appeals affirming the trial court's rulings in favor of the plaintiff on the above issues. The *Pummill* case was remanded to the District Court "with instructions to hear and decide the disputed fact issues."

A 3-day bench trial was subsequently conducted before the District Court in October 2015. In January 2016, the District Court issued a 74-page decision that in large part rules in favor of the Pummill plaintiffs. An appeal of that ruling was filed by the defendants in February 2016. Multiple amicus curiae participants were allowed to file briefs. The briefing of the issues on appeal was completed in August 2016, and the parties and the industry are awaiting the Oklahoma Court of Appeals' decision.

The *Pummill* case, given its prior long procedural history, appears to provide the best opportunity for litigants to reach the Oklahoma Supreme Court for the purpose of obtaining the much-needed clarification of the status of royalty law in Oklahoma under the 1998 landmark decision in *Mittelstaedt v. Santa Fe Minerals, Inc.,*[15] in which many rulings regarding the deductibility of post-wellhead costs from royalty payments were made

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14. Order reversing in primary part and affirming in part, issued by the Oklahoma Supreme Court on November 17, 2014.

15. 954 P.2d 1203 (Okla. 1998).

by the Oklahoma Supreme Court. However, a number of key issues were left unresolved.

B. Appellate Court reverses District Court order certifying a royalty owner class.

On November 24, 2015, the Oklahoma Court of Appeals in *Tipton Home, Trustees v. Burlington Resources Oil & Gas Company, L.P.*,[16] reversed an order certifying a class of over 500 royalty and overriding royalty owners in some 22 wells located in 3 Oklahoma counties. The plaintiffs alleged that the defendant paid royalties based on non-arm's length sales to an affiliate, and based on the weighted average price received for the affiliate sales. The plaintiffs further alleged that Burlington improperly deducted, in the computation of royalty payments, costs for gathering, compression, dehydration, treatment and processing (GCDTP costs) and fuel use, and failed to disclose those deductions on its check stubs.

In reversing the class certification order, the Court of Appeals found that the proposed class did not satisfy the commonality and predominance requirements under 12 O.S. § 2023. Among other findings, the court held that individual issues predominated over common issues. The court observed that the question of where and when particular gas is "marketable" is not settled in Oklahoma, and there is no categorical rule in the state with respect to when post-production costs may be considered for royalty valuation. The court also held that the mere raising of a common question does not automatically satisfy § 2023(A)(2)'s commonality requirement. . . Instead, the common contention "must be of such a nature that it is capable of classwide resolution—which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke." . . . "What matters to class certification . . . [is] the capacity of a classwide proceeding to generate common answers apt to drive the resolution of the litigation."

C. District Court denies request for certification of statewide class.

The decision on class certification in *McKnight v. Linn Operating, Inc.*[17] was the first Oklahoma Federal District Court ruling on the question of class certification of royalty owner lawsuits in the aftermath of the important guidance provided by the United States Court of Appeals for the

16. 86 O.B.J. 2540 (Okla. App. 2015 - # 111,735) (Not for Publication).
17. No. CIV-10-30-R, 2016 WL 756541 (W.D. Okla. Feb. 25, 2016).

10th Circuit in its rulings in July 2013 in two appeals that were pursued by XTO Energy, Inc.[18] In both of those prior appeals, the 10th Circuit granted XTO's request for a reversal of the District Courts' orders granting class certification, with directions to conduct new evidentiary hearings in accordance with the rulings and directives of the 10th Circuit.

The plaintiff royalty owners in *McKnight* sued the Linn defendants alleging that royalties had been underpaid, with the primary focus of the lawsuit being on the factoring of post-production costs into the computation of royalty payments. The *McKnight* case was filed by the plaintiffs in November 2009 seeking certification of a royalty owner class relating to certain Oklahoma wells of the Linn defendants. The Plaintiff's Motion for Class Certification was heard by the District Court in February 2016. McKnight sought certification of a statewide class.

The lengthy and complex "class definition" that the McKnights ultimately proposed to the Court occupies two pages of text in the District Court's order of February 25, 2016. The class requested would have included 1,693 wells in the state of Oklahoma, over 30,000 putative class members and some 34,000 oil and gas leases.

Certain of the key observations and rulings of the Federal District Court in the McKnight case were as follows:

Early in its ruling, the District Court described its general perception of the underlying transactional relationship between oil and gas producers and midstream companies—using words that many in the oil and gas industry would take exception to (as did the Linn defendants) in certain respects—by stating as follows: "Producers, like the [Linn] Defendants herein, often enter into contracts with midstream companies which process the gas under either percentage of proceeds ('POP'), fee or keep-whole contracts. Typically, these contracts allow the midstream companies to acquire title or possession of the unprocessed and therefore unmarketable gas at the wellhead or somewhere upstream of the midstream company's processing facilities and producers then declare that a 'wellhead sale' has occurred and contend that the raw gas is 'marketable' at the wellhead. This is an attempt to seemingly comply with the implied duty to market. However, the midstream companies provide the services of gathering, compressing, dehydrating, treatment and processing ('GCDTP') the gas and then

18. Chieftain Royalty Company v. XTO Energy, Inc., 528 F. Appx. 938 (10th Cir. July 9, 2013), applying Oklahoma oil and gas law, and *Wallace B. Roderick Revocable Living Trust v. XTO Energy, Inc.*, 725 F.3d 1213 (10th Cir. 2013), applying Kansas oil and gas law. The 10th Circuit Court of Appeals essentially treated those two cases as companion appeals and decided the appeals through separate decisions issued the same date.

remitting to the producer either a percentage of what the midstream company receives from the purchaser (POP) or the amount received from the pipeline minus a fee in kind or in cash charged for performing the GCDTP services. Producers then calculate and pay royalties based on the net amounts received from the midstream companies rather than the gross amount the midstream companies receive from the pipeline sales. By calculating the royalty payments on such net amounts, the royalty owners bear the costs of transforming the raw gas into a marketable product."[19]

With regard to the four requirements for certification of a class under F.R.Civ.P.23(a) (i.e. numerosity, commonality, typicality and adequacy), the District Court first noted that numerosity was not in dispute. As to the requirement of commonality, the McKnight plaintiffs had listed some 24 questions of law or fact that were alleged to be common to the proposed class members. However, the Court found that many of the proposed common questions could not be answered for all class members in a single stroke, but instead required individualized inquiries by class member, by well and by month. Still others among the alleged common questions would not generate answers apt to drive resolution of the case.

The District Court found that the Linn Defendants' evidence showed that: (a) Linn uses more than 2,500 division order pay decks to dictate whether class members are exempt or non-exempt from deductions for the various gathering, compressing, dehydrating, treating and processing (GCDTP) services on a month-by-month basis to determine how royalty owners are paid; (b) Linn does not calculate and pay royalty to class members using a uniform methodology; and (c) whether royalty owners receive deductions for various GCDTP services is also impacted by how Linn's revenue accounting department codes those services. The District Court found that those facts rendered McKnight's proposed common questions to be questions that cannot be answered on a class-wide basis. However, it further concluded that there were at least two common questions of law that would generate common answers for the entire class and were apt to drive resolution of the litigation.

With regard to the requirement of "typicality," the District Court noted, citing one of the XTO decisions referred to above, that "[t]he Tenth Circuit has instructed district courts to consider whether variances in lease language and gas marketability have effect on typicality." In concluding that the typicality requirement was not met, the Court found that "the differing methods of paying the royalty owners and in particular the

19. 2016 WL 756541 (W.D. Okla. 2016).

payment methodology used on production from [the McKnights' single well at issue in this case] renders the [McKnights'] claims not typical of the class claims. Unlike the owners of hundreds of other wells, costs associated with moving the [McKnight well] gas downstream from the lease were recorded by Linn accountants to compression and transportation cost codes for which the McKnights were not exempt, rather than to 'Gath' or 'Gathpa' codes, for which the McKnights and thousands of other owners in hundreds of other wells were set up as 'exempt' from deductions."

In reviewing the fourth requirement under Rule 23(a) of "adequacy," the District Court indicated that it had serious questions as to whether the McKnights, as proposed Class Representatives, could vigorously prosecute the proposed class action. The McKnights had testified that they had never seen or read their lease or check stubs and had no knowledge of the lease's terms, including how it required royalties to be calculated and whether deductions were permitted.

The Court found that the elements of F.R.Civ.P. 23(b)(1) could not be met in this case. As to F.R.Civ.P. 23(b)(3), which is the most commonly-cited subsection of Rule 23(b) when courts have been asked to certify royalty owner classes, the District Court ruled that common questions of law and fact did not predominate in the McKnight lawsuit over questions affecting only individual members "because of Defendant Linn's complex method of calculating and paying the individual royalties. Linn does not pay all royalty owners across the board in the same manner. A determination of how much Linn paid each royalty owner and a second inquiry as to how much it should have paid each owner will require owner by owner and month by month calculations with examination of whether Linn's pay decks listed owners as exempt from some or all deductions for post-production services and an examination of how Linn's revenue accounts 'booked' certain deductions."

Finally, after reviewing the very lengthy proposed class definition referenced earlier, the District Court found that class membership was not objectively ascertainable. Rather, the Court would be required to hold evidentiary hearings to determine which potential class members qualified for inclusion and exclusion from the class as proposed to be defined by the McKnight plaintiffs.

D. Colorado court addresses the deductibility from royalties of a proportionate share of certain types of costs of reaching a downstream market located beyond the first commercial market.

The case of *Lindauer v. Williams Production RMT Company*,[20] involved a class action royalty lawsuit, initiated in Colorado state district court in 2006, challenging the manner in which Williams Production RMT Company, now known as WPX Energy Rocky Mountain, LLC ("WPX"), calculated and paid royalties. The parties reached a "partial" settlement in 2008 that resolved all but two claims. Only the second unsettled claim was before the Court of Appeals at this time—*i.e.*, the plaintiffs' assertion that WPX improperly deducted from royalties a proportionate share of transportation costs incurred beyond the first commercial market during certain months from 2000 to July 2008.

The key marketing and post-wellhead costs circumstances were as follows: WPX incurred certain compression, gathering and processing costs in connection with the gas. Once processed, the gas reached the tailgate of the gas processing plant and entered a large mainline pipeline. The costs of processing and moving the gas up to the point it reached the tailgate were not deducted in computing royalties.

Although there was a commercial market for the gas at or near the tailgate of the plant, WPX sold some of the gas in downstream markets where higher prices were available. To be sold to those markets, the gas had to be transported to the point of sale. In order to secure transportation of the gas, WPX entered into long-term contracts with mainline pipeline companies in order to reserve capacity for the transportation of the gas from the tailgate to the downstream markets.

The downstream transportation charges involved two components. First, a "demand charge" paid by WPX to reserve space in the mainline pipelines for the gas it delivered to the lines. The demand charge was owing and had to be paid without regard for whether or not WPX used the pipeline to ship gas. However, under WPX's established procedures, demand charges were only deducted in computing royalty payments in the months when the particular royalty owners' gas was shipped. The second component paid for the transportation services was a "commodity charge" paid by WPX per unit volume actually shipped on the pipeline. Those commodity charges were deducted from the revenues in arriving at the royalty payments to the plaintiffs.

20. 381 P.3d 378 (Colo. App. 2016). Note: At the time this paper was written, the plaintiff was seeking further review before the Colorado Supreme Court.

It was undisputed in this case that the plaintiffs' oil and gas leases were *silent* regarding the allocation or deduction of gas transportation costs. Accordingly, the parties agreed that the framework recognized in *Garman v. Conoco, Inc.*[21] and *Rogers v. Westerman Farm Co.*[22] governed the issue. The parties also agreed that the tailgate of the processing plant was, under the facts of this case, the first commercial market for the gas and that the transportation costs incurred *prior to that point* were not deductible from royalties. At issue here was whether the costs incurred to transport the gas to downstream markets *beyond the first commercial market* were deductible.

The plaintiffs argued, based upon the holdings in *Garman* and *Rogers*, that the costs WPX incurred to transport gas downstream were deductible only if WPX could show that (1) the costs were reasonable (the "reasonableness test"), and (2) the actual royalty revenues were increased in proportion with the costs assessed against the royalties (the "enhancement test"). The plaintiffs did not contest the reasonableness of the transportation costs, but they disputed whether actual royalty revenues increased in proportion to those costs. Specifically, the plaintiffs asserted that WPX must show that the royalty revenues increased on a "month-by-month" basis by comparing the downstream prices at the point of sale to the price of gas at the first commercial market.

In response, WPX first argued that the enhancement test does not apply to costs incurred to transport the gas to downstream markets. Alternatively, WPX argued that, even if the enhancement test applied, it must be determined based on the "prudent operator rule" rather than a month-by-month price comparison. Under that approach, the court would consider the overall reasonableness of WPX's decisions to enter into long-term transportation contracts, as well as the long-term benefits to royalty owners as a result of WPX's downstream marketing strategy.

Prior to trial, the district court entered two orders resolving WPX's arguments in favor of the plaintiffs. First, it found that the enhancement test applies to all costs incurred after the gas becomes marketable in order to be deductible from royalty payments, and that WPX bore the burden of proof in showing an actual increase in royalty revenues. Second, the district court required that WPX apply the enhancement test on a month-by-month basis, and it rejected WPX's contention that the enhancement test should be evaluated based on the prudent operator rule.

21. 886 P.2d 652, 661 (Colo. 1994).
22. 29 P.3d 887, 903 (Colo. 2001).

The court then held a bench trial to measure the price of gas at the first commercial market against the downstream price. At that trial, WPX showed that its downstream marketing strategy allowed it to *substantially increase the volume of production* from the plaintiffs' wells during the 8 year period at issue. Combined with the price increase that was also received downstream as to many months, WPX maintained that overall revenues for the 8 year period as a whole were approximately $6 million higher that if the gas had been sold at the first commercial market (*i.e.*, at the tailgate of the plant). However, the district court found that WPX did not prove enhancement of the price as to 35 months of the 8-year period, and it ordered an accounting. Based on that accounting, the district court entered judgment against WPX for $5,136,296.95. WPX appealed.

The Colorado Court of Appeals agreed with WPX and held that the rules of law pronounced in *Garman* and *Rogers do not* require post-marketability transportation costs to meet the enhancement test in order to be deducted from royalty payments. The court further held that other considerations militated against imposing an enhancement test on transportation costs. The court concluded that "post-marketability transportation costs are deductible if they are reasonable, and that lessees are not required to establish that such costs enhance the value of the gas or increase royalty revenues."[23] The court further found that the statute on which the district court relied had no bearing on whether the enhancement test applied to the deductibility of post-marketability transportation costs. Because of those holdings, the court did not need to address whether the enhancement test must be applied on a moth-by-month basis.

In reaching the above conclusions, some of the more notable findings of the Colorado Court of Appeals were as follows:

The *Lindauer* court noted that the royalty owners in *Garman* conceded that (1) the transportation costs associated with moving marketable gas from the tailgate of the processing plant (where the gas entered the interstate pipeline) to the point of sale were properly deductible, and (2) the costs incurred to process raw gas into its component parts after a marketable product had been obtained were generally deductible to the extent they were reasonable, provided such operations actually enhanced the value of the product.[24] Referencing those concessions, the court in *Garman* then stated the rule that is referred to as the enhancement test.[25]

23. *Lindauer*, 381 P.3d at 381.
24. *Garman*, 886 P.2d at 655, n. 8.
25. *Lindauer*, 381 P.3d at 382.

Contrary to the Lindauer plaintiffs' contention, the *Garman* decision did not address whether post-marketability *transportation costs* are subject to the enhancement test. Indeed, Garman quoted language from a treatise stating that "*[a]fter a marketable product has been obtained*, then further costs in improving or transporting such product should be shared by the lessor and lessee. . ."[26]

In order to deduct certain post-marketability *processing costs* that enhance the value of an already marketable product, the court in *Garman* held that the lessee must show that (1) the costs are reasonable and (2) actual royalty revenues increased in proportion with the deducted costs.[27] The Colorado Supreme Court in *Garman* treated *processing* costs and *transportation* costs as separate categories, and only the *reasonableness* requirement was mentioned with respect to transportation costs.[28] Accordingly, the *Garman* decision did not expressly require post-marketability transportation costs to meet the *enhancement* test in order to be deductible.

In the *Rogers* case, the Colorado Supreme Court "reaffirmed its holding in *Garman* and concluded that where a lease is silent on the issue, the implied covenant to market requires the lessee to bear all costs of obtaining a marketable product."[29] However, contrary to the plaintiffs' contention and the district court's interpretation, *Rogers* did not expressly state that the enhancement test applies to all post-marketability costs.[30]

The court noted the statements in *Rogers* that "[o]nce a product is marketable, however, additional costs incurred to either improve the product, or transport the product, are to be shared proportionately by the lessor and lessee. All costs must be reasonable."[31] "Thus, when referring to the deduction of post-marketability *transportation* costs, the court in *Rogers* required only that such costs be 'reasonable'."[32]

In sum, the Court of Appeals concluded that neither *Garman* nor *Rogers* require that *transportation costs*, incurred after the first commercial market,

26. *Garman*, 886 P.2d at 661, n.27 (quoting 3 Eugene Kuntz, *A Treatise on the Law of Oil and Gas* § 40.5 (1979 & 1994 Supp.))

27. *Id*. at 382-83.

28. *Id*. at 383.

29. *Id*.

30. *Id*.

31. *Id*.

32. *Id*.

enhance the value of the gas or increase royalty revenues in order to be deducted from royalty payments.[33]

Additionally, the Colorado Court of Appeals found that other considerations militate against requiring transportation costs to meet the enhancement test. Imposing an enhancement requirement on transportation costs, particularly on a month-by-month basis, ignores the commercial realities of the marketplace.[34] The court found that an enhancement test which compares gas prices in downstream markets to those in markets closer to the wells and field,

> does not account for the significant increase in the volume of gas produced from plaintiffs' wells as a result of downstream marketing. There was evidence presented at trial that plaintiffs realized a tenfold increase in the volume of gas produced during the eight-year period at issue, and a mere price comparison does not indicate whether the same volume of gas could have been sold in the local market. Moreover, WPX maintains that its decision to transport gas out of the Piceance Basin altered local prices, and it is unlikely that those same prices would be available had the gas only been sold locally.[35]

The court further found that the enhancement test urged by the Lindauer plaintiffs and imposed by the district court failed to take into account the long-term nature of decisions to market gas downstream. WPX presented evidence at trial that it had to invest in long-term transportation contracts to guarantee access to downstream markets and to obtain higher downstream prices, and that those decisions could not be made or changed on a monthly basis. "Thus, a month by month enhancement requirement is inconsistent with the long-term nature of the downstream marketing strategy and its long-term benefits."[36]

The court noted that the rule proposed by the district court and the plaintiffs "would give plaintiffs a 'free ride' by allowing them to enjoy the

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33. *Id*. at 385. The court noted that the Lindauer plaintiffs had additionally cited the Oklahoma Supreme Court's decision in Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998). The court noted that *Mittelstaedt* "cited *Garman* in applying the enhancement test to transportation costs incurred after the gas was marketable. 954 P.2d 1203, 1208 (Okla.1998). However, *Mittelstaedt* was decided before our supreme court announced *Rogers*, and, in any event, the Oklahoma court's application of *Garman* is not controlling in Colorado." *Lindauer* 381 P.3d at 385.

34. *Lindauer* 381 P.3d at 385.

35. *Id*.

36. *Id*.

long-term benefits of WPX's downstream marketing strategy in certain months, while avoiding paying their proportionate share of the costs in other months."[37]

Finally, the court rejected the contention that certain Colorado Statutes[38] which required lessees to pay royalties and report deductions on a monthly basis and provide a written explanation of those deductions upon request (*i.e.*, check stub statutes) provided any support for the application of an enhancement test to post-marketability transportation costs.

Since the plaintiffs did not challenge the *reasonableness* of the transportation costs incurred to reach the downstream markets, the Court of Appeals concluded that those costs were deductible from royalty payments and reversed the judgment of the district court.

E. Kansas Federal District Court Provides Preliminary Comments Regarding the 2015 Fawcett Decision of the Kansas Supreme Court Addressing Deductions From Royalty Payments.

The court in *Roderick Revocable Living Trust v. XTO Energy, Inc.*,[39] considered the plaintiff's motion to amend its complaint in light of the pronouncements of Kansas royalty law that were part of the 2015 decision in *Fawcett v. Oil Producers, Inc. of Kansas*.[40] The court consolidated its consideration of the plaintiff's motion to amend with a like motion pending before him by the plaintiff in *Roderick Revocable Living Turst v. OXY USA, Inc*.[41] In both cases, the plaintiff royalty owners "claim that the Defendants underpaid them for gas produced from Kansas wells, in part by deducting from their payments the costs of rendering the gas marketable. The parties agree upon the applicability of the "Marketable Condition Rule" ("MCR"), an outgrowth of the implied duty to market, which broadly provides that the cost of making gas marketable falls solely on the operator-lessee, and not on the royalty owner-lessor."[42]

The U.S. District Court noted that the royalty owners in *Fawcett* "argued the raw gas was not marketable, for purposes of the MCR, until it enters an interstate pipeline, but the court disagreed. Although it noted 'what it means to be "marketable" remains an open question [in Kansas].' "[43] The district

37. *Id*. at 385-86.
38. Section 34-60-118.5(2), (2.3) and (2.5).
39. No. 08-1330-EFM-GEB, 2016 WL 742879 (D. Kan. Feb. 24, 2016).
40. 352 P.3d 1032 (Kan. 2015).
41. U.S. District Court for the District of Kansas, Case No. 12-1215-EFM-GEB.
42. 2016 WL 742879 at *1.
43. *Id*. at *3 (citing *Fawcett*, 352 P.3d at 1042).

court further observed that the Kansas Supreme Court in *Fawcett* "injected into its analysis the concept of good faith and fair dealing."[44]

The parties in the present *Roderick* cases sought to amend their complaints "to clarify [their] claims in light of the *Fawcett* ruling, and specifically to include allegations which reflect the duty of good faith articulated in *Fawcett*. However, both defendants oppose amendment or supplementation of the pleadings, arguing that amendments are untimely and futile in light of the *Fawcett* ruling."[45] More specifically, the defendants asserted that "*Fawcett* did not actually introduce the concept of a good faith sale into the marketability determination, because the duty of good faith and fair dealing is implied in every contract and the implied duty to market has long incorporated its own good faith element."[46] The defendants argued that, as a consequence, it was misleading for Roderick to suggest that this was a "new" claim, and Roderick should have included allegations regarding good faith from the inception of each case, such that the current motions were untimely.

The district court rejected the foregoing argument, finding: "While the concept of good faith is clearly not new, the Kansas Supreme Court's <u>focus</u> on the concept, and suggested analysis of those factors which could demonstrate good faith, does appear novel. Therefore, the Court does not find Plaintiff's delay to be undue or unexplained."[47]

Additionally, the defendants argued that "the *Fawcett* ruling clearly rejected Plaintiff's entire theory of recovery under the MCR, because Plaintiff's claim thus far has been that the gas we not marketable (and Defendants bore full responsibility for making it so) until it reached interstate pipeline quality—very similar to the *Fawcett* plaintiffs' claims. Therefore, Defendants argue Plaintiff's proposed amendment is futile and should be denied."[48] However, the district court found that the defendants' contention was "an oversimplification of the *Fawcett* ruling, which found the definition of marketability, while not necessarily defined by the interstate pipeline quality, could not be decided as a matter of law."[49] The court concluded that it could not find the proposed amendments to the complaints, based largely on the *Fawcett* ruling, to be futile.

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44. *Id*. (citing *Fawcett*, 352 P.3d at 1042).
45. *Id*. at *4.
46. *Id*. at *5.
47. *Id*. (Emphasis added by the court).
48. *Id*. at *6.
49. *Id*.

The district court granted the plaintiff's motions to amend its complaint to add allegations taking into account the *Fawcett* decision.

F. Federal District Court in Kansas Grants Motion to Decertify Class Based Upon the Fawcett, Roderick and Wal-Mart Decisions That Were Issued After the Certification of the Class in 2011.

In *Wallace B. Roderick Revocable Living Trust v. OXY USA, Inc.*,[50] OXY moved the court to decertify a plaintiff royalty owner class certified in 2011 by the state District Court of Kearny County, Kansas before the case was removed to federal court. The court described the pertinent principles of Kansas royalty law as follows:

Corollary to this implied duty to market [the minerals produced] is the marketable condition rule, which "requires operators to make gas marketable at their own expense." These duties can be contractually disclaimed. If the duties were not disclaimed in this case, OXY would have been required to make the raw gas marketable and to bear the accompanying costs. Steps taken to make raw gas marketable often include gathering, compression, dehydration, treatment, and processing ("GCDTP") services. But in other circumstances, gas may be marketable at the well.[51]

The plaintiffs (Roderick) sued OXY in March 2008 alleging that OXY improperly deducted from royalty payment certain costs associated with rendering gas into marketable condition. Roderick sought to certify a class of all royalty owners in Kansas wells operated by OXY. The proposed class comprised approximately 1,900 wells and 2,300 oil and gas leases. Those wells connected to 8 different gas gathering systems, and gas was delivered to 5 different plants for processing. OXY sold some of the raw gas at the wellhead pursuant to 17 different gas purchase agreements. The rest of the gas was produced and marketed as follows: Most of the gas production was subject to 6 separate processing agreements with third-party plants. There were also 6 gathering agreements, 3 transportation agreements and 2 separate helium purchase agreements.

Royalty payments were based on these multiple contracts, and so the royalty payments varied accordingly. Roderick contends that all of the above transactions on which royalties were based took place "before any

50. No. 12-1215-EFM-GEB, 2016 WL 3423133 (D. Kan. June 22, 2016).

51. *Id*. at *1 (citing *Fawcett*, 352 P.3d at 1034; Sternberger v. Marathon Oil Co., 894 P.2d 788, 800 (Kan. 1995)).

GCDTP services had been performed on the gas"[52] and that royalties were based on prices for gas that was not in marketable condition.

After the class was certified, the case was removed to federal court. "Since then, the United States Supreme Court, the Tenth Circuit Court of Appeals, and the Kansas Supreme Court have each issued decisions that directly impact class certification analysis and Kansas oil and gas law. Relying on these recent developments, OXY now moves to decertify the class."[53]

The court concluded that Roderick's plausible road to recovery is different now than it was when the class was certified in 2011, and that Roderick's new road involves different issues which are not common to the class as currently certified. In reaching that conclusion, some of the primary findings of the court were as follows:

The court rejected Roderick's argument that the issue of when the gas from the class wells reached "marketable condition" was a common issue because the plaintiff contends that "none of the gas in question was marketable until it had been processed, reached commercial grade, and was sold to a third party."[54] The court found that the 2015 decision of the Kansas Supreme Court in *Fawcett*

> rejected the proposition that marketability can be determined as a matter of law, and went on to hold that an operator's duty to make gas marketable is satisfied "when the operator delivers the gas to the purchaser in a condition acceptable to the purchaser in a good faith transaction." This "good faith" qualification impacts the Court's commonality determination. *Fawcett* made clear that the question of marketability is a factual one. There is no "precise quality or condition at which gas becomes marketable." Rather, the marketability of gas is "an open question" that depends on the parties' willingness to buy and sell it. The gas in this case reached marketable condition when OXY delivered it in a condition acceptable to the purchaser. Tying the marketability of gas to a precise quality or condition is no longer a viable theory of recovery.[55]

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52. *Id*. at *2.

53. *Id*. (citing Wal-Mart Stores, Inc. v. Dukes, 131 S.Ct. 2541 (2011); Wallace B. Roderick Revocable Living Trust v. XTO Energy, Inc., 725 F.3d 1213 (10th Cir. 2013); Fawcett v. Oil Producers, Inc. of Kansas, 352 P.3d 1032 (Kan. 2015)).

54. *Id.* at *3.

55. *Id.*

The court further observed that, in order to prevail under a theory of "breach of the marketable condition rule," Roderick would need to illustrate that the gas was not in a marketable condition at the wellhead, and thus OXY's deductions were improper. To contest marketability, Roderick would need to challenge OXY's contention that in "its various wellhead agreements," OXY was delivering gas in a condition acceptable to the purchaser in a good faith transaction. The court found that, given this framework, the class certified in 2011 did not satisfy Rule 23(a)(2). The question of when the gas at issue in this case reached marketable condition is not "of such a nature that it is capable of classwide resolution." Instead, that determination would require individual inquiries into each marketing contract to assess whether, under *Fawcett*, the gas was in marketable condition.[56]

The court found that, if Roderick challenged the good faith of the transaction, the agreements would have to be so uniform in substance and formation that their good faith could be determined in a single stroke. Otherwise, a class action challenging the good faith of a transaction would be limited to wells subject to a single agreement.[57]

The court concluded that if Roderick can illustrate that the question of marketability, as defined by *Fawcett*, is common to a given class of royalty owners, then a class action may be proper. However, "those allegations were not made when this class was initially certified, and are not made here. The class as presently constituted is improper. OXY's motion to decertify is granted."[58]

G. Court addresses inter alia claims for royalty on fuel used in operations and on drip condensate, whether royalty was owed based on the gross volume of gas produced at the wellhead, and whether the lessee has a duty to "trace the gas molecules" from the lessors' well to the exact downstream market to which those molecules were delivered and sold.

The case of *Anderson Living Trust v. Energen Resources Corp.*[59] presented, in the U.S. District Court for the District of New Mexico, a series of royalty issues including whether fuel used in operations and drip condensate were royalty bearing under the facts presented and whether the

56. *Id.* at *4.
57. *Id*.
58. *Id.*
59. 161 F. Supp. 3d 1055 (D.N.M. 2016).

lessee has a duty to, as some have termed it, "trace the molecules of gas" from a given producing well to a specific downstream gas buyer.

The plaintiffs owned royalty and overriding royalty interests in oil and gas leases of Energen, and in wells, located in two states; however, this decision addressed only the plaintiffs' claims under New Mexico law.[60] The plaintiffs sued Energen alleging claims that the court found could all be fairly described as allegations of royalty underpayment, even though the manner of the alleged underpayments may differ. The court noted that the plaintiffs did, however, dismiss their claim for underpricing.[61]

Energen incurred costs for post-production services performed by third parties in order to gather, compress and process the gas produced from the subject New Mexico wells. Energen deducted the third-party expenses it incurred for those purposes. The plaintiffs did not challenge the reasonableness of these monetary deductions, nor did they contend that the costs were excessive or were not actually incurred by Energen. Rather, they only objected to the fact that those costs were deducted from their royalty payments.

The New Mexico plaintiffs had "royalty agreements (or overriding royalty agreements)" that addressed the calculation of royalties. The Anderson-Pritchett lease provided for royalties on the "market value [of the gas] at the well. The comparable provision in the Neely-Robertson lease provided for payment on the "prevailing field *market* price." "As Defendant observes, there are no functional differences between the two leases for purposes of calculating royalties because both provisions are based on the market value or price of the gas at the well. This lease language means that before royalties are paid, the market value for gas at the well must be determined."[62]

The plaintiffs asserted that they should be paid royalties based on the volume of the gas produced at the wellhead, "arguing that gas volume is greatly reduced after processing and after reductions that occur from use of plant fuel. In other words, Plaintiffs want to be paid based on the particular number of molecules of gas coming out of the wellhead."[63] However, the court found that "there is no way to pay Plaintiffs an actual 'price' for gas from an individual well because the tracing of individual molecules of gas 'is physically impossible from the moment the gas enters' the gathering

60. *Id*. at 1056.
61. *Id.* at 1057.
62. *Id*. at 1058-59.
63. *Id*. at 1059.

system."[64] The court found that the plaintiffs offered no argument for *why* they were entitled to royalty payments based strictly upon the share of gas produced from their wells, nor would any such argument be supported by the royalty provisions contained in their leases. Rather, the court concluded that the language in the two oil and gas leases (which referred to "market value" and "prevailing field market price") clearly intended for royalty payments to be based on the downstream value of the gas at its market value.[65]

In concluding that Energen was entitled to summary judgment on all claims asserted by the plaintiffs under New Mexico law, the court reached many additional noteworthy findings, conclusions and rulings, with some of the key ones being as follows:

The plaintiffs' argument against the deduction of post-production costs "ignores the operable language calling for payments to be based on 'market value.' " The court cited *Abraham v. BP America Production Co.*[66] in which the 10th Circuit held that a market-value royalty owner is entitled to be paid based on the market value of unprocessed gas at the well, or an acceptable estimation of that value through a netback calculation. Under the netback or work-back method for calculating the market value of gas at the lease, "costs of transportation, processing, or manufacturing are deducted from the proceeds received for the gas. The value of gas using the 'netback' or 'workback' methodology is determined by taking the downstream sales price and deducting from it the costs incurred by the working interest owner to move the gas from the point of valuation to the actual point of sale."[67] The court concluded that, "in accordance with New Mexico law, Energen is entitled to deduct post-production costs for its services in getting the gas into a marketable condition."

As part of the compensation to the third-party processor under their agreement, Energen reimbursed the processor for all taxes, including the New Mexico natural gas processors tax. Energen treated the reimbursed taxes like any other post-production cost and deducted it in computing royalty payments. The royalty owners argued that they should not have to pay the tax because the underlying statute made the gas processor liable for the tax instead of the interest owners. The court found that there is no

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64. *Id*. In connection with that finding, the court cited In re Assessment Against Mo. Gas Energy, 234 P.3d 938, 944 (Okla. 2009), and W. W. McDonald Land Co. v. EQT Production Co., 983 F.Supp.2d 790, 803 (S.D. W. Va. 2013).

65. *Energen*, 161 F. Supp. 3d at 1060.

66. 685 F.3d 1196, 1203 (10th Cir. 2012)

67. *Energen*, 161 F. Supp. 3d at 1060.

language in the applicable New Mexico statute[68] which suggests that the privilege tax cannot be shared with the royalty owner in the form of a royalty deduction in order to cover reimbursement to the processor who by statute was designated to be the party to remit the tax. Moreover, the court found that the deductibility of the tax as a post-production cost called for a return to the oil and gas lease language which the court had already determined allowed for the deduction of post-production costs under New Mexico law, which does not recognize a duty to market on the part of the producer.[69]

Energen allowed the third-party processors to keep the fuel used in downstream processing as an in-kind cost or compensation in the form of free field and plant fuel. The third-party processors use field fuel to run compressors in the field to compress the gas in order to move it downstream, or plant fuel, which is fuel that is used in the processing plant and is consumed by the plant in order to process the gas and extract liquids or to otherwise improve the gas. The royalty owners asserted that they should be paid royalties on the gas used by the processors in-kind for its production services. The court noted that it was uncontested that Energen did not sell that gas, that it did not market that gas, and that it received no proceeds for that gas. Under the leases, the royalty owner plaintiffs were entitled only to royalties on the market value or market price of the gas. "Because the field and plant gas used in the processing was not sold and Energen received no proceeds from that gas, it cannot be considered gas that was marketed and so no royalties are owed."[70]

In its order granting the operator's motion for summary judgment, the court then engaged in a lengthy analysis of the impact of the varying wording in the "free use" provisions in the underlying oil and gas leases on the royalty underpayment claims.

The royalty owners finally claimed that Energen failed to pay royalties on "drip condensate," asserting that Energen was not entitled to free use of the drip condensate. Energen responded that the drip condensate was not used by the processors. Rather, the gatherers were entitled to retain the drip condensate as part of their compensation for their gathering and processing services pursuant to a contract between Energen and those third parties. The royalty owners countered that "plaintiffs never agreed to allowing Energy to give away drip condensate to these third parties."[71] However, the court

68. N.M. STAT. ANN. § 7-33-4 (2016).
69. *Energen*, 161 F. Supp. 3d at 1061-62.
70. *Id*. at 1062.
71. *Id*. at 1067.

found that the plaintiff royalty owners "cannot have it both ways." The royalty owners cannot demand to be paid based on the volume produced at the wellhead (where values for gas are lower), while also insisting that the royalties on those wellhead volumes be valued based on the enhanced value of the gas downstream, without sharing in any of the costs involved to increase its value for market.

The court concluded that "Energen is entitled to summary judgment on all claims asserted by Plaintiffs under New Mexico law."[72]

H. Court addresses issue of whether the producer was allowed to deduct in computing royalties a "pro rata allocation" (as opposed to the actual volumes for each well) of the lost and used gas, when the applicable oil and gas lease did not contain express wording addressing the issue. Court also addresses whether there is a duty on the part of producers to "trace the molecules of gas."

The royalty owner appellants in *Hall v. CNX Gas Company, LLC*[73] presented on appeal a single issue that the court described as a being one of *first impression*:[74] "Whether a natural gas producer may allocate [to the royalty owners a 1/8th share of[75]] lost and used gas even without a provision in the lease authorizing it to do so when, under established Pennsylvania law, oil and gas leases are to be narrowly construed and the rights not directly conferred by the lease language are to be considered withheld by the lessor?"[76] The applicable royalty provision quoted by the court provided as follows:

> Royalties. The royalties to be paid by the Lessee are:
>
> . . . .
>
> (b) *on gas,* including casinghead gas or other gaseous substances, produced from said land and sold or used beyond the

72. *Id*. at 1069.
73. 137 A.3d 597 (Pa. Super. Ct. 2016).
74. *Id*. at 601.
75. *Id*. at fn. 9.
76. *Id*. at 600-01. In Footnote 4 of the decision, the court noted that the Halls had also alleged at the inception of the dispute that the allocation of post-production costs was not permitted by the lease. However, they subsequently withdrew that claim in light of the Pennsylvania Supreme Court's decision in Kilmer v. Elexco Land Servs., Inc., 605 Pa. 413, 990 A.2d 1147 (2010), which the court in Hall described as holding that a lease that utilized the net-back method to allocate post-production costs for purposes of calculating royalties did not violate the GMRA (*i.e.,* the Guaranteed Minimum Royalty Act, 58 P.S. § 33).

> well or for the extraction of gasoline or other product, an amount equal to one-eighth of the net amount realized by Lessee computed at the wellhead from the sale of such substances. On gas sold at the well, the royalty shall be one-eighth of the amount realized by Lessee from such sale.[77]

The court found that "the bulk of the gas is not sold at the wellhead but is transported via pipeline downstream to the point of sale. The Hall lease provides that, for gas sold or used beyond the well, Lessor is entitled to a royalty of one-eighth of the net amount realized from the sale. This is generally referred to as a proceeds lease, and the parties agree that royalties are payable only on the gas sold."[78] The Hall lease gave the lessee the right to drill and operate the Halls' wells in conjunction with the wells on neighboring properties, and further gave the lessee the right to use, free of cost, "oil, gas and water produced on said land for its operations."[79]

The gas produced from the Hall properties feeds into a gas gathering system. At various points along that pipeline, gas produced from other wells is commingled with that of the Halls and is transported to the point of sale. The lessee, CNX, described its method for computing royalties as follows:

> The royalty payment to each [lessor] is computed by dividing the volume of gas as measured at each well head by the total volume of gas measured at all of the wellheads that feed into the sales point. This value is multiplied by the amount realized on the sale by CNX to compute each well's proportionate share of the amount realized from the sale.[80]

The Halls contended that since the lease did not authorize the "pro rata allocation" of lost and used gas among the lessors, CNX was limited to deducting only "actual volumes" of lost and used gas from each lessor's share of the royalty. As CNX did not measure the volume of gas from each well just prior to the point of commingling, and therefore could not attribute to an individual well the precise amount of gas lost or used from that well, the Halls contended that CNX was obligated to pay royalties based on the volume of gas measured at each wellhead with no reduction.

77. *Id*. at 598-99.
78. *Id*. at 599.
79. *Id*.
80. *Id*.

CNX moved for summary judgment on the basis that, due to the fungible nature of the compound and the physical impossibility of independently tracking each molecule from its source, it was impossible to attribute any specific amount of gas lost or used to any one of the individual wells along the pipeline.[81] CNX asserted that no royalty was due on gas that was lost or used prior to the point of sale, and it maintained that it did not deduct an allocated amount of lost and used gas from the royalty payable on each well.[82] The Halls argued that, without language in the oil and gas lease permitting a proportionate *allocation* of lost and used gas, CNX could deduct from their royalties only the amount of gas actually lost and/or used as measured from each well.[83] The Halls essentially argued that they were entitled to royalties based on the volume of gas *produced* as measured at each wellhead, despite the lease provision calculating the royalty on the volumes of gas *sold.*[84]

The trial court entered summary judgment in favor of CNX. The royalty owners appealed. In affirming the lower court's ruling in favor of CNX, the court noted that the lease provides that royalties are to be based on the net amount realized at the point of sale, and that the volume of gas that was lost and used is not part of the royalty calculation in the present case. "Gas lost or used on the way to the point of sale is simply not part of the royalty computation. It necessarily follows that lost and used gas is not allocated when the royalty is allocated among the various lessors."[85]

Regarding the issue of whether the lessee has a duty under the lease to be able to trace the actual production from each wellhead to the place of sale so that it knows the specific market at which those particular volumes were sold, the court cited the earlier case of *Pollock v. Energy Corp. of Am.*,[86] in which the court looked to expert testimony regarding industry custom and practice to the effect that "it has long been the custom in the industry to combine gas production from several wells and the use a reasonably method of allocation to calculate the royalties for the individual wells.[87] However, the court found in its concluding ruling that, since the language

81. *Id*. at 600-01.

82. More specifically, CNX asserted that royalties were "calculated when the gas was sold, and at that point, the lost and used gas was not in existence. In short, royalties were not due on lost and used gas as it did not reach the point of sale." *Id*. at 603.

83. *Id*. at 602.

84. *Id*.

85. *Id*. at 604.

86. No. 10-1553, 2013 WL 275327 (W.D. Pa. Jan. 24, 2013).

87. *Hall*, 137 A.3d at 604-05.

of the oil and gas lease provided the basis of its ruling, there was no need for the court to "consider the wisdom of importing industry custom and practice to supply missing contract terms."[88]

I. Texas Supreme Court denies motion for rehearing with respect to its 2015 decision in the Hyder case and issues substituted opinion in 2016.

In *Chesapeake Exploration, L.L.C. v. Hyder*,[89] a 5-4 majority of the Texas Supreme Court denied Chesapeake's motion for rehearing that had been filed with respect to its June 12, 2015, decision in the case. The majority issued a substituted opinion making few changes to their original opinion.

The court in *Hyder* was presented with a suit for the alleged underpayment of the sums due under the "overriding royalty" provisions of an oil and gas lease that provided for both royalty and overriding royalty payments. The Hyders alleged that their overriding royalty payments were free of postproduction costs and that Chesapeake had improperly deducted postproduction expenses in computing the Hyders' payments. After a bench trial, the court ruled in favor of the Hyders and awarded them $575,359.90 as a result of the cost deductions. The Texas Court of Appeals affirmed. The Texas Supreme Court granted discretionary review.

The Texas Supreme Court began its decision with the following statement:

> Generally speaking, an overriding royalty on oil and gas production is free of production costs but must bear its share of postproduction costs unless the parties agree otherwise. The only question in this case is whether the parties' lease expresses a different agreement. We conclude it does and therefore affirm the court of appeals' judgment.[90]

The oil and gas lease at issue in this case contained three royalty provisions—an oil royalty clause, a gas royalty clause[91] and a clause

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88. *Id*. at 605.

89. 483 S.W.3d 870 (Tex. 2016).

90. *Id*. at 871.

91. The lease contains three royalty provisions. One is for 25% of "the market value at the well of all oil and other liquid hydrocarbons." No oil is produced from the lease. Another royalty is for 25% "of the price actually received by Lessee" for all gas produced from the leased premises and sold or used. The lease adds that the royalty is expressly "free and clear of all production and post-production costs and expenses," and lists examples of various expenses. The third provision, the one here in dispute, calls for "a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent (5.0%) of

providing for "a perpetual cost-free (except only its portion of production taxes) overriding royalty of five percent (5.0%) of gross production obtained"[92] from directional wells drilled on the lease but bottomed on nearby land.

The lease additionally included a provision to the effect that "Lessors and Lessee agree that the holding in the case of *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996) shall have no application to the terms and provisions of this Lease." The lease also gave each lessor the option to take their royalty share in kind.[93] However, no lessor had ever exercised that option.

The Hyders and Chesapeake agreed that the overriding royalty was free of production costs; however, they dispute whether it is also free of postproduction costs. The gas from the subject wells was sold by Chesapeake to an affiliate, Chesapeake Energy Marketing, Inc. (CEMI). CEMI then gathered and transported the gas through both affiliated and interstate pipelines for sale to unaffiliated third party purchasers in distant markets. The gas price paid by CEMI to Chesapeake was determined based on the weighted average of the third party sales prices, less postproduction costs. The Hyders contend that their overriding royalty should be based on the gas sales price paid by the third party buyers without any deduction of postproduction costs.

After a bench trial, the trial court rendered judgment for the Hyders and awarded them $575,359.90 in postproduction costs that the court found were wrongfully deducted by Chesapeake in computing their overriding royalty payments. The Texas Court of Appeals affirmed.

The Texas Supreme Court granted Chesapeake's Petition for Review. In affirming the decisions below, the Texas Supreme Court held in part as follows:

The court stated that "we long ago defined an overriding royalty as 'a given percentage of the gross production carved from the working interest but, by agreement, not chargeable with any of the expenses of operation.' That agreement is now understood to be part of an overriding royalty, and an overriding royalty is like a landowner's royalty in that it usually bears postproduction costs but not production costs, though the parties may agree to a different arrangement."[94]

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gross production obtained" from directional wells drilled on the lease but bottomed on nearby land. *Id*. at 871-72.

92. *Id*. at 872.

93. *Id*.

94. *Id*. at 872-73.

The Hyders argued that the language of the lease made the overriding royalty free of postproduction costs. Specifically, they asserted that the wording in the lease providing "that the overriding royalty be 'cost-free' can only refer to postproduction costs, since the royalty is by nature already free of production costs without saying so."[95] However, the court noted that, as with the gas royalty, "cost-free" may simply emphasize that the overriding royalty is free of production costs. So the court disagreed with the Hyders that "cost-free" in the overriding royalty provision could not refer to production costs. "As noted above, drafters frequently specify that an overriding royalty does not bear production costs even though an overriding royalty is already free of production costs simply because it is a royalty interest. But Chesapeake must show that while the general term 'cost-free' does not distinguish between production and postproduction costs and thus literally refers to all costs, it nevertheless cannot refer to postproduction costs here."[96]

"Chesapeake argues that the gas royalty provision shows that when the parties wanted a postproduction-cost-free royalty, they were much more specific. But as we have already said, the additional detail in the gas royalty provision serves only, if anything, to emphasize its cost-free nature. The simple 'cost-free' requirement of the overriding royalty achieves the same end."[97]

The court rejected the Hyders' contention that their override was free from postproduction costs because of the above-referenced provision in the lease that specifically disclaimed any application of the holding in the prior *Heritage Resources* case: "Heritage Resources does not suggest, much less hold, that a royalty cannot be made free of postproduction costs. Heritage Resources holds only that the effect of a lease is governed by a fair reading of its text. A disclaimer of that holding, like the one in this case, cannot free a royalty of postproduction costs when the text of the lease itself does not do so. Here, the lease text clearly frees the gas royalty of postproduction costs, and reasonably interpreted, we conclude, does the same for the overriding royalty. The disclaimer of Heritage Resources' holding does not influence our conclusion."[98]

The court acknowledged that "[w]ere the Hyders to take their overriding royalty in kind, as they are entitled to do, they might use the gas on the property, transport it themselves to a buyer, or pay a third party to transport

95. *Id*. at 873.
96. *Id*. at 874.
97. *Id*. at 875.
98. *Id*. at 876.

the gas to market as they might negotiate. In any event, the Hyders might or might not incur postproduction costs equal to those charged by Marketing. The lease gives them that choice. . . The fact that the Hyders might or might not be subject to postproduction costs by taking the gas in kind does not suggest that they must be subject to those costs when the royalty is paid in cash. The choice of how to take their royalty, and the consequences, are left to the Hyders. Accordingly, we conclude that 'cost-free' in the overriding royalty provision includes postproduction costs."[99]

Four of the nine justices of the Texas Supreme Court joined in a dissenting opinion.

J. Court rejects effort by new plaintiff to seek class certification as to a similar royalty owner class as another court refused to certify in a prior case involving a different plaintiff (i.e., no second bite at the apple)

In the early years following BP-Amoco's success in defeating class certification in the case of *Watts v. Amoco Production Company*,[100] different plaintiff counsel, representing a different plaintiff, sought certification of a royalty owner class against BP in a different Oklahoma county district court in spite of the earlier court's denial of class certification in the *Watts* case. In *Rees v. BP America Production Co.*,[101] the Oklahoma Court of Appeals found that the new attempt at certification of a class action lawsuit (*i.e.*, the second bite at the apple so to speak) was precluded by the denial of class certification in the earlier *Watts* case. The reasoning applied by the Court of Appeals is explained in its opinion.

Unit Petroleum encountered a like scenario after defeating class certification in the earlier case of *Panola Independent School District No. 4 v. Unit Petroleum Co.*[102] A different plaintiff lawyer, representing a different plaintiff, sought certification of a royalty owner class against Unit in a different court in *Consul Properties, LLC v. Unit Petroleum Co.*[103]

In its Order of February 2, 2016, the U.S. District Court in *Consul*, citing and discussing the above-referenced *Rees* decision from 2008, dismissed the portion of the *Consul* case that requested class certification (apparently leaving the case pending only as to the individual claims of the named plaintiffs). The Court found, among other things, that "there is an identity

99. *Id*. at 875.

100. 75 O.B.J. 2459 (Okla. App. 2004 - #98,782).

101. 211 P.3d 910 (Okla. App. 2008).

102. 287 P.3d 1033 (Okla. App. 2012).

103. Order dated February 2, 2016, in Case No. CIV-15-840-R, United States District Court for the Western District of Oklahoma.

of interest between the named plaintiffs in *Panola* and the named Plaintiffs in this [*Consul*] case sufficient to constitute privity. But in any event, Oklahoma as a matter of state law has clearly recognized [*e.g., Rees v. BP America Production Co.*] non-mutual defensive collateral estoppel or issue preclusion to apply in the circumstances of this case."

K. Third Circuit Court of Appeals affirms District Court ruling that the arbitration clauses in the subject oil and gas leases did not allow the royalty owners to seek class-wide arbitration.

In *Chesapeake Appalachia, LLC v. Scout Petroleum, LLC,*[104] Chesapeake had entered into certain oil and gas leases covering property in Pennsylvania which contained the following arbitration clause:

> ARBITRATION. In the event of a disagreement between Lessor and Lessee concerning this Lease, performance thereunder, or damages caused by Lessee's operations, the resolution of all such disputes shall be determined by arbitration in accordance with the rules of the American Arbitration Association.[105] All fees and costs associated with the arbitration shall be borne equally by Lessor and Lessee.

Scout Petroleum, LLC and Scout II, LP (collectively referred to as "Scout") purchased the lessors' rights under several of the above leases and thereafter received royalty payments from Chesapeake. In March of 2014, Scout filed an arbitration demand against Chesapeake on behalf of itself *and similarly situated lessors*, alleging that Chesapeake had underpaid royalties. In its answering statement filed with the American Arbitration Association (AAA), Chesapeake objected to the proposed class arbitration, asserting that it never agreed to resolve disputes arising out of the subject

104. 809 F.3d 746 (3d Cir. 2016). On October 3, 2016, the United States Supreme Court denied certiorari review.

105. The court noted that, over the years, the American Arbitration Association (AAA) has adopted and amended more than 50 sets of active rules, including the Commercial Arbitration Rules and Mediation Procedures as well as the Supplementary Rules for Class Arbitrations. 809 F.3d at 749. The court further noted that AAA Commercial Rule 7 states in part that "[t]he arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope, or validity of the arbitration agreement or to the arbitrability of any claim or counterclaim." *Id*. Commercial Rule 8 states in part that the arbitrator shall interpret and apply these rules insofar as they relate to the arbitrator's powers and duties." *Id*. at 750. Other provisions of the AAA rules were quoted by the court in its opinion, including provisions contemplating the possibility of class arbitrations.

leases through a *class* arbitration. Chesapeake additionally stated that it did not agree to submit the question of whether a class arbitration was maintainable under the leases for decision by the arbitrator (instead of the courts).

Chesapeake promptly filed the present declaratory judgment action in April 2014 asking the federal district court to declare (1) that the district court, and not the arbitrators, must decide whether class arbitration was available, and (2) that the subject oil and gas leases do not permit class arbitration.

In July 2014, in an unrelated lawsuit, the U.S. Court of Appeals for the Third Circuit (the court before which the present appeal was pending) issued its opinion in *Opalinski v. Robert Half International Inc.*[106] The district court found that *Opalinski* changed the state of law in the Third Circuit by holding "for the first time, that 'the availability of classwide arbitration is a substantive "question of arbitrability" to be decided by a court absent clear agreement otherwise.' "[107]

On October 6, 2014, the three appointed arbitrators (all of whom were retired federal judges) issued a decision that noted the holding in *Opalinski* and found that the arbitration clauses in this case met the required standard and clearly and unmistakably authorized the panel to make the decision about arbitrability. Chesapeake filed motions to vacate the arbitrators' ruling and to stay the arbitration until the federal district court ruled on Chesapeake's pending request for a finding on the question of "who decides" whether the lease provisions allowed for class arbitrations.

On October 16, 2014, the district court granted Chesapeake's motion, it found that the court is to decide the issue of arbitrability and it vacated the arbitrator's decision that they (rather than the court) should decide the issue of arbitrability of class-wide claims, finding that the arbitrators' ruling was contrary to *Opalinski*:

In its memorandum opinion, the District Court concluded that

> [t]he contract here is silent or ambiguous as to class arbitration, far from the 'clear and unmistakable' allowance needed for an arbitrator, and not a court, to turn to the clause construction question."[108] In reaching this conclusion, it relied in particular on

106. 761 F.3d 326 (3d Cir. 2014).

107. Chesapeake Appalachia, L.L.C. v. Scout Petroleum, LLC, 73 F. Supp. 3d 488, 499 (M.D. Pa. 2014) (quoting *Opalinski*, 761 F.3d at 329).

108. The Third Circuit explained that "the clause construction" inquiry is the question of whether the parties' arbitration agreement permits class arbitration. 809 F.3d at 753.

> this Court's opinion in *Opalinski* as well as the Sixth Circuit's decision in *Reed Elsevier, Inc. v. Crockett.*[109]

On appeal, Scout argued that the arbitration clauses contained in each of the leases expressly and unambiguously delegated the question of arbitrability to the arbitrators. In support of that assertion Scout urged that (1) the leases expressly stated that the arbitration would be conducted in accordance with the rules of the American Arbitration Association, (2) under Pennsylvania law, the arbitration provisions incorporated all of the AAA rules into the leases, as part of the parties' agreement, as if fully printed *in haec verba* therein, and (3) the AAA's Commercial and Supplementary Rules, as integral parts of the Leases, thereby clearly and unmistakably vested the arbitrators with the jurisdiction to decide the question of class arbitrability.[110] However, the Third Circuit disagreed and held that the leases failed to satisfy the applicable onerous burden of overcoming the presumption in favor of judicial resolution of the question of arbitrability.

The court did observe that "[v]irtually every circuit to have considered the issue has determined that incorporation of the [AAA] arbitration rules constitutes clear and unmistakable evidence that the parties agreed to arbitrate arbitrability. Like the District Court and Chesapeake, however, we believe that this 'bilateral arbitration dispute case law' is entitled to relatively little weight in the class arbitrability context. . . . [T]he whole notion of class arbitration implicates a particular set of concerns that are absent in the bilateral context.[111]

Turning to the second question of whether the arbitration clauses in the oil and gas leases contemplated the ability to submit class-wide issues to arbitration, the Third Circuit found that "the Leases are, at least in a certain sense, 'silent as to the availability of classwide arbitration. . . . [L]ike *Opalinski* and *Reed Elsevier*, the Leases do not expressly mention class arbitration, the availability of class arbitration, the Supplementary Rules . . ."[112]

The court found that "the requisite contractual basis may not be inferred solely from the fact that the parties agreed to arbitrate or from their failure to prohibit this form [class arbitrations] of arbitration in their agreement.[113]

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109. 809 F.3d at 752. Reed Elsevier, Inc. v. Crockett 734 F.3d 594 (6th Cir. 2013).
110. 809 F.3d at 753-54.
111. *Id*. at 764.
112. *Id*.
113. *Sutter*, 675 F.3d at 221, 224.

"'[T]he differences between bilateral and class-arbitration are too great for arbitrators to presume . . . that the parties' mere silence on the issue of class-action arbitration constitutes consent to resolve their disputes in class proceedings.' "[114]

In addition to emphasizing the total absence of any reference to classwide arbitration in the arbitration clauses of the leases, the court also found it "significant that the Leases consistently use singular (and defined) terms to describe the respective parties to any arbitration proceeding and the dispute to be arbitrated.[115] The Third Circuit noted that, in considering the arbitration clause in *Reed [Elsevier]*, the Sixth Circuit looked only to whether there was an express reference to class arbitration in the arbitration clause. The court observed that, given its examination of both the language of the leases and the nature and contents of various AAA rules, it saw no reason to reach a different conclusion in the present case, and thereby create a split among the circuits.

The Third Circuit affirmed the orders of the district court.

L. Case to Note for Future Reference: Court addresses issues as to the "Standing" of the plaintiffs to assert certain claims in connection with alleged royalty underpayments in a proposed class action lawsuit, and the Court also discusses objections filed by both the plaintiffs and defendants to certain Expert Witness testimony proposed by the opposing parties.

In a very lengthy opinion that we will not attempt to summarize in this paper, the United States District Court for the District of New Mexico in *Abraham v. WPX Production, LLC*[116] addressed in detail a series of questions on whether the plaintiffs lacked standing to assert certain of their royalty underpayment claims.

The court also addressed in the same order the objections the opposing parties had filed to the suitability of the proposed expert testimony to be offered by two well-known expert witnesses and/or participants in class action royalty lawsuits throughout the oil and gas producing states. This case should be noted for future reference in the event that issues on those same subjects arise in the reader's present and future litigation.

114. *Id*. at 221 (quoting *Stolt-Nielsen*, 130 S.Ct. at 1776).
115. 809 F.3d at 759-60.
116. 184 F. Supp. 3d (D. N.M. 2016).

III. Oil and Gas Lease Cancellation, Termination and Breach of Obligation Cases (Other Than Royalty)

A. Court addresses claims of lease termination based on alleged failure to produce in paying quantities as to a well from which no oil or gas had been marketed for a period of some 17 years.

The case of *Concorde Resources Corp. v. Williams Production Mid-Continent Co.*,[117] involved an oil and gas lease termination lawsuit. The Connor #1 gas well was drilled and completed in 1981 to the Booch formation and was shut-in in 1982. Concorde acquired the original oil and gas leases attributed to that well, which covered the SW/4, the N/2 SE/4, the SW/4 SE/4 and NW/4 of Section 12. Concorde acquired the original leases and the Connor #1 as part of a settlement of litigation. However, the assignment was not recorded either as a documented settlement or an official assignment of record. The prior owner did file with the Oklahoma Corporation Commission a notice of the change of operator.

In 1990, Concorde acquired new oil and gas leases from the same lessors who were subject to the original leases. However, the new leases only covered the SW/4 of Section 12. The new leases were duly recorded in the real estate records. Concorde presented testimony at trial that the new leases were acquired in order to reduce the spacing and reduce the shut-in payments, and that the Connor #1 well had been capable of production in paying quantities since the time it was drilled and completed in 1981.

The Court of Appeals noted that the two issues in this appeal were: (1) Whether the original leases and the new leases terminated because of the inability of the Connor #1 well to produce in paying quantities when it was "turned on" in July of 2008, and (2) whether Redbud E&P and its predecessors acquired the original leases as to certain formations as a result of an Oklahoma Corporation Commission pooling order.

The history of the Connor #1 well, as shown by the testimony and evidence presented at trial, was as follows:

The well was drilled and completed in 1981.

Concorde deepened the well in 1990 to the Middle Booch formation, without success.

From 1990 to 2008, Concorde did not perform any other activities in connection with the well other than checking well pressure, usually twice a year. The pressure reading was between 380 and 440 pounds.

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117. 379 P.3d 1157 (Okla. Civ. App. 2016).

Also during the same period of 1990 to 2008, Concorde did not expend funds for operation or maintenance of the well, and Concorde did not sell any gas from the well. Additionally, Concorde did no further exploration. Concorde did not dispute this period of inactivity.

With there being no contrary evidence, Concorde maintained that there was no pipeline connection available until July 2008, and the trial court found that to be true. The parties stipulated for trial that Redbud was making no claim that the implied covenant to market had been breached.

A pipeline became available in 2008. Concorde connected the well to the pipeline in July 2008, tested the line and waited for a gas sales contract. The well was turned on without any problem—such as water or any need for repairs—and gas was sold.

A compressor was added which aided in transportation of the gas in the pipeline and had no function in enabling production.

From about 1990, the well had a water tank and separator. Concorde replaced both in June 2008. The well was "turned on" and began producing gas. The well was not "loaded" with water and the water produced was consistent with water produced generally with gas production.

Concorde's records reflected 110 barrels of water during the first approximate 30 days of production in 2008. Redbud argues that this amount is excessive and shows that the well was in fact "loaded" with water. The trial court found that the water removal did not equate to adding additional equipment or repair.

An expert and fact witness for Concorde presented rebuttal to the assertions of problems with the well and opined that the well was capable of producing gas in paying quantities when it was shut-in. He also testified that the compressor's function was for transportation rather than production. However, on cross-examination, this witness testified that he did not know the capability of the well in 2008. He also stated that, without a separator, the gas purchaser would not purchase the gas with water content.

The court of appeals' opinion includes 8 more paragraphs summarizing the detailed testimony and other evidence presented at the trial, and reference is made to paragraphs 14 through 21 of that opinion for the remaining factual backdrop that was described in the opinion.

The trial court held in favor of Concorde with regard to the lease issues and denied damages. Redbud appealed.

In affirming in part, modifying in part and remanding the case back to the trial court with instructions, the court of appeals found in part as follows:

1. Title to the original leases and the new leases merged as to the SW/4 of Section 12. “When a legal estate and an equitable estate are coextensive and become vested in the same person, there is a merger of the equitable estate in the legal estate and a consequent extinguishment of the equitable estate, and survival of the legal estate, absent any intent not to merge. First Federal Savings and Loan Ass'n, Chickasha, Oklahoma, 1992 OK 129, ¶ 5, 839 P.2d at 1340.”[118]

2. Here it is clear that Connor #1 produces gas in paying quantities. The contested issue in this case is whether the well had the ability to produce when the market became available in June 2008, rather than the actual production at a later time.[119] The question in this case is whether the well had the ability to produce in paying quantities when the impediment (no pipeline) to marketing was removed.[120] Redbud’s view of the evidence is that the Connor #1 required repair and additional equipment before it could be “turned on” and begin flowing gas. In addition, Redbud points to the total absence of any marketing of production for 17 years.

3. The determination of whether a well is "capable of producing in paying quantities" involves equitable considerations conducted on a case-by-case basis. Looking at the status of a well at a precise moment in time might overlook rational explanations of whether a well is, or is not, capable of producing in paying quantities. Here, it is clear that the trial court, expressly or implicitly, examined the facts pertinent to Connor #1 in accordance with the foregoing criterion. The trial court's conclusion that Connor #1 is a well capable of producing in paying quantities is not against the clear weight of the evidence or contrary to law.[121]

4. As to Redbud’s claim that it acquired right in other formations by virtue of an Oklahoma Corporation Commission pooling order (a proceeding to which Concorde was a party), the court of appeals agreed that Redbud acquired the interests (outside the producing formation in the Connor #1 well) as to the force pooled Savanna, Red Fork, Hartshorne and Bartlesville formations. As a result, the trial court’s judgment quieting title in Concorde was directed to be modified to exclude those formations from the ownership findings in favor of Concorde.

118. *Id*. at 1162.
119. *Id*.
120. *Id*. at 1163.
121. *Id*. at 1165.

B. Landowners seek preliminary injunction prohibiting Lessee from terminating its supply of natural gas via farm taps under the "Free Gas Clauses" of the oil and gas leases.

The landowner plaintiffs in *Lee v. ConocoPhillips Company*[122] sued ConocoPhillips (Conoco) to enforce their interpretation of the free gas clauses contained in the underlying oil and gas leases. Those clauses permitted

> lessors to have gas free of charge from any gas well on the leased premises for stoves and inside lights in the principal dwelling house on said land by making their own connections with the well, the use of said gas to be at the lessors' sole risk and expense.

The gas was to be provided in its raw, natural state, at its natural pressure. Residential gas lines, farm taps and domestic taps, were built and connected from the landowners' properties to Conoco's wellheads to allow the landowners to take and use the raw gas. Throughout the period leading up to the proceedings in this case, Conoco provided the landowners with natural gas, free of charge, pursuant to the free gas lease provisions. The decision of the court recounts in detail the factual history of free gas use by the landowners, and safety concerns of Conoco, and the efforts of Conoco to buy-out the free gas rights in order to terminate the provision of raw free gas to the landowners. The court notes in its decision that "Conoco's initiatives have been generally successful; most farm taps on its wells in Oklahoma have been eliminated. Only the farm taps involved in the present litigation remain."[123]

During the period leading up to the filing of the landowners' lawsuit, Conoco had expressed growing concerns about the risks associated with the landowners' taking and use of untreated, unodorized gas, and whether the landowners were complying with federal and state rules and regulations that applied to the facilities they constructed to transport the free gas to their property. It urged the landowners to find alternate sources for natural gas, and offered a financial payout. When those communications failed to lead the landowners to end their use of the free gas option, Conoco notified certain of the plaintiff landowners that it was going to disconnect their farm taps by a specified date due to the volatile mixture of untreated elements in the gas, and it provided a list of alternate providers of gas. Other

122. No. CIV-14-1391-D, 2016 WL 67803 (W.D. Okla. Jan. 5, 2016).
123. *Id*. at *3.

landowners were advised that their taps would be disconnected unless they provided proof that they were in compliance with specified regulations of the U.S. Department of Transportation that are administered by the Oklahoma Corporation Commission.

As the landowners approached the deadline by which their taps were apparently going to be disconnected, they filed suit in the state district court of Texas County, Oklahoma and sought injunctive relief with respect to the intended disconnection of the taps. The landowners further sought a declaratory judgment that Conoco was required to comply with its contractual obligation to make natural gas available to landowners. Conoco removed the case to federal court and sought declaratory relief that, *inter alia,* it was not obligated to continue providing natural gas under the leases, due to stated concerns, and that it could turn off, disconnect and disable the farm taps without liability to the landowners.

Before the court in this decision was the landowners' motion for a preliminary injunction prohibiting Conoco from terminating the supply of natural gas via the farm taps during the pendency of the lawsuit. The court analyzed the pertinent factors required in order for a preliminary injunction to be granted as follows:

As to whether the landowners had shown a likelihood of success on the merits, the court cited the earlier decision of the U.S. District Court in Kansas in *Schell v. OXY U.S.A., Inc.*[124] The court in *Schell* found that since the free gas clause provided that the lessors were entitled to free gas for domestic purposes, this necessarily meant free "useable" gas, and that the "sole risk and expense" (of lessor) wording only came into play after the lessee fulfilled its obligation to provide the lessors with free, useable gas for domestic purposes.[125] The court in the present *Lee* case likewise found that the subject leases were ambiguous but that, construing the lease language most strongly against the lessee, the free gas clauses required the lessee to provide the landowners with free, useable gas.

The court additionally found that the landowners' right to free gas was part of the consideration for, and a right granted by, the underlying oil and gas leases and that the lessee could not disregard its obligations out of mere inconvenience or expense. "Conoco's argument regarding the added risks is not substantially different from the attendant risks it has in conducting its exploration and production activities."[126]

124. 822 F. Supp. 2d 1125 (D. Kan. 2011).
125. *Lee*, 2016 WL 67803 at *7.
126. *Id*.

The court next it did not "interpret Conoco's purported obligation to ensure Landowners' lines are in regulatory compliance to mean it can arbitrarily shut off the farm taps and permanently discontinue service in violation of its contractual obligation to provide free useable gas. This is especially true where Conoco has been providing such services for years without substantial interference or interruption."[127]

As a final finding in evaluating the landowners' likelihood of success on the merits, the court concluded that "the fact Landowners may use the gas for purposes other than that specified in the leases does not, in the Court's view, constitute a material breach that would justify the cessation of such rights, since '[t]he fact that the lessor has used gas for unauthorized purposes does not affect the right to free gas for authorized purposes.' *See* 4 KUNTZ, *supra* at 374. In sum, the likelihood of success factor weighs in Landowners' favor."[128]

In assessing the required showing of "irreparable harm" in order to obtain a preliminary injunction, the court stated

> damages may be measured by either using the value of the gas which should have been provided or the difference in the value of the property with or without the free gas. Also, evidence at the preliminary injunction hearing showed the production life of a well may be determined by using the 'decline curve' methodology." Moreover, ample evidence was introduced which establishes that Landowners have available to them alternate means of obtaining natural gas of the option of converting their fuel supply to propane. Of course, the utilization of either alternative is an exercise for which monetary damages would suffice to make Landowners whole. . .[129]

Since the landowners failed to make an adequate showing of irreparable harm, the court found that it did not need to consider the remaining factors that must be shown in order to obtain a preliminary injunction.

However, the court noted in concluding its decision that if the lessee chose to act on its stated intent to shut off the landowners' farm taps even pending final adjudication of the case, "the court directs Conoco to reasonably assist Landowners in locating and connecting an alternative source of energy, and to temporarily refrain from shutting off the farm taps

127. *Id*.
128. *Id*.
129. *Id*. at *8.

for a reasonable time in order to allow such alternative sources to be put in place."[130]

C. Summary judgment ruling terminating oil and gas lease under its 90-day cessation of production clause is reversed based upon finding of disputed issues of material fact.

In *Brammer Petroleum, Inc. v. Bagley Minerals, L.P.*,[131] the trial court had entered summary judgment in favor of Bagley based on a finding that three oil and gas leases terminated because Brammer failed to commence operations for more than 90 days after a cessation of production, as required under the lease terms. On appeal, Brammer asserted that the trial court improperly struck from the record a portion of Larry Brammer's affidavit, there was a disputed issue of fact as to whether Bagley had denied Brammer access to the well, there was a disputed issue of fact as to whether there was a cessation of production for more than 90 days, and Bagley failed to plead and prove the elements of their trespass-to-try-title claim.

In reversing and remanding the case based upon a finding that whether production ceased for more than 90 days remained a disputed issue of fact, the Texas Court of Appeals focused on the fact that the contract pumper for the well at issue presented records showing that there was no production from the well in May, June and July 2013. However, the summary judgment record also included the pumper's deposition testimony. In the deposition, the pumper was shown, and acknowledged, documents placed in front of him that showed 69 Mcf of gas produced and disposed of in July of 2013. Since a reasonable fact finder could infer from the deposition testimony that there was production from the well in July 2013, the summary judgment ruling was reversed and the case was remanded for further proceedings.

IV. Oil and Gas Contracts, Transactions and Title Matters

A. Appellate Court affirms holding by the District Court that an AMI letter agreement was invalid under the Rule Against Perpetuities.

In *American Natural Resources, LLC v. Eagle Rock Energy Partners, L.P.*,[132] the two primary questions before the Court were (1) whether a clause in an agreement giving American Natural (ANR) the right to participate in all future wells on unleased property violates Article II,

130. *Id*.
131. No. 06-15-00091-CV, 2016 WL 3212496 (Tex. App. June 8, 2016).
132. 374 P.3d 766 (Okla. 2016).

Section 32 of the Oklahoma Constitution prohibiting perpetuities, and (2) whether a limited liability company is a "life in being" for purposes of that provision of the Oklahoma Constitution.

The agreement at issue in this case was a 2005 letter agreement contained the following provision which allowed ANR the right to participate in future wells (the "Option Provision"):

> 2. In all subsequent wells within the AMI, ANR shall have the right to participate in the prospect area with a twenty-five percent (25%) working interest . . .

ANR alleged in this suit that the defendants drilled and completed 17 wells in the AMI without allowing ANR to participate, and that the defendants thereby breached the above obligation under the agreement. ANR sued for (1) damages for alleged breach of contract, (2) damages for intentional interference with prospective economic benefits, and (3) a declaratory decree from the Court finding that ANR was entitled to participate in future wells drilled under the AMI since the date of the agreement. The defendants moved to dismiss the lawsuit, alleging that the Rule Against Perpetuities prevented ANR from enforcing the Option Provision. ANR responded that the Rule Against Perpetuities does not apply to oil and gas operating agreements and does not apply to the Option Provision because oil and gas production is always of limited duration.

The district court granted the motion to dismiss based upon the Rule Against Perpetuities. ANR appealed. The Oklahoma Court of Appeals remanded the case to the district court so that ANR could amend its pleadings and for a determination of "whether, if alleged, a personal contract and a specific or perpetual organization life, together or separately, suffice to create an exception to the application of the Rule Against Perpetuities as set out in Producers Oil Co. v. Gore, 1980 OK 62, 610 P.2d 772."[133]

In vacating the Court of Appeals' decision and affirming the district court's dismissal of the case, the Oklahoma Supreme Court held in part as follows:

In rejecting the contention that the Option Agreement was inherently limited in duration, the court observed that the Option Agreement in this case was not part of a JOA or an oil and gas lease. The option did not expire when an existing lease expires, but instead continues when new leases are executed with new wells to be drilled on those leases. The AMI agreement

133. *Id*. at 769.

in this case was found to be a stand-alone document Simply put, "the Option Provision provides for ANR to participate in wells *infinitum* and is subject to the rule against perpetuities."[134]

Additionally, the court found that ANR, as a Limited Liability Company, could not be a life in being under the Rule. It further stated that, when there is no measureable life in being (such as with a corporation or an LLC), "the only definite period permitted by the rule against perpetuities is a term not exceeding 21 years."[135] Thus, "the Option Period was subject to the twenty-one year limit imposed by the rule against perpetuities and [the *Melcher* case]. ANR's right to participate in future wells is indeterminable, does not vest within the twenty-one year limit, and may never vest. Thus, the Option Provision violates the rule against perpetuity."[136]

B. Court resolves disputes regarding the effect of Pugh Clauses contained in the oil and gas leases.

In *Natural Gas Anadarko Company v. Venable*,[137] the plaintiff NGAC sued the defendant-lessors for a judicial determination as to the scope of NGAC's remaining leasehold rights under the "Pugh clauses" contained in NGAC's leases. The Pugh clauses stated in primary part as follows:

> 2. Lessee agrees to release any portion of the leased premises not included in a producing unit or is not currently being drilled on a unit as designated by the Corporation Commission upon the expiration of the primary term of this lease . . .

NGAC asserted that it continued to hold <u>all</u> the common sources of supply at all depths within its leases by production from those two wells and two formations. However, lessors maintained that the 1eases expired at the end of their primary term as to all common sources of supply that were not producing on that date. In substance, NGAC alleged that the clause was a "vertical" Pugh clause that kept the leases in effect as to *all zones or formations* within the 640-acre geographic area where the two wells were producing from two common sources of supply or formations. In contrast, the lessors asserted that it was a "horizontal" Pugh clause that caused the leases to terminate as to all formations that were not within the Oklahoma Corporation Commission-established common source(s) of supply producing at the end of the primary term.

134. *Id*. at 770.
135. *Id*. at 771.
136. *Id*.
137. 86 OBJ 1558 (Okla. App. 2015 - #111,611) (Not for Publication).

Both the trial court and Court of Appeals ruled in favor of the lessors. The appellate court distinguished the prior decision in *Rist v. Westhoma Oil Co.*[138] on the basis that the Pugh clause in this case contained restrictive language not found in the Pugh clause under consideration in *Rist*. The court found that the clause here "clearly expresses the intent of the parties to prohibit lease continuation as to unproductive units."

C. Court determines whether prevailing parties in quiet title action were entitled to recover their attorney fees and costs under the Nonjudicial Marketable Title Procedures Act.

The decision in *Natural Gas Anadarko Company v. Venable*,[139] involved the appeal of the district court's judgment awarding costs and attorney fees to the Venable defendants after they prevailed on the merits in the quiet title action described in the preceding case summary of this paper. In that appeal, the court held that Anadarko's leases expired at the end of the primary term with respect to the one nonproducing drilling and spacing unit designated by the Oklahoma Corporation Commission but not as to the two producing units. The Court of Appeals affirmed the trial court's judgment quieting title in the Venable defendants as to the nonproducing drilling and spacing unit.

Anadarko's appeal of the award of attorney fees and costs challenged the Venable defendants' statutory entitlement to costs and attorney fees under the Nonjudicial Marketable Title Procedures Act (NMTPA).[140] Anadarko contended that the attorney fee portion of the Act does not apply. Anadarko argued that attorney fees are authorized only if a party prevails on its entire claim. Anadarko noted that although it did not obtain the relief it sought, it did obtain some relief--*i.e.*, the validity of its leases as to the two producing formations was confirmed.

In affirming the district court's award of attorney fees and costs to the Venable defendants under the NMTPA, the court found in part as follows:

The court began its analysis by describing the purposes and policies that underlie the NMTPA as follows:

> The Nonjudicial Marketable Title Procedures Act "sets forth detailed procedures to be followed where someone having an interest or claiming an interest in a parcel of real property and who believes there is some title defect or apparent cloud on the

138. 385 P.2d 791 (Okla. 1963).
139. 368 P.3d 3 (Okla. Civ. App. 2015).
140. 12 O.S. §§ 1141.1-1141.5.

> title to the real property, seeks to remedy same without having to institute a court action to quiet title." *Head v. McCracken*, 2004 OK 84, ¶ 17, 102 P.3d 670, 681. The Act "seeks to preserve judicial resources by encouraging resolution of title disputes through curative instruments rather than through quiet title actions. It accomplishes this purpose by requiring a trial court to award attorney fees, costs, and expenses to a prevailing party in a quiet title action who attempted to first resolve the matter through a curative instrument in accordance with the Act." *Stump*, 2007 OK 97, ¶ 9, 179 P.3d at 611.[141]

With regard to the above-referenced argument of Anadarko that it did obtain some relief in this action which should preclude an award of fees and costs against Anadarko, the court first agreed with the trial court's prior finding that the validity of Anadarko's leases as to the two producing formations was never an issue in the case. Rather, what Anadarko sought was clear and uncontested title to the nonproducing formation. On that issue, the Venable defendants prevailed. The Venable defendants were correct in refusing to execute the curative document requested by Anadarko before the lawsuit was filed. The court found that Anadarko "must win . . . through the quiet title court proceedings that which they sought through their written demand."[142]

Second, the court found that Anadarko could not recover attorney fees pursuant to the NMTPA unless "a defendant refuses to execute a curative instrument that is actually necessary to cure the title problem."[143] However, no similar restriction is placed on a defendant who defeats only a portion of the plaintiff's quiet title action. The NMTPA authorizes recovery of attorney fees by a quiet title defendant who correctly "failed or refused" to take the corrective action demanded by the plaintiff in its pre-lawsuit request.[144]

With regard to the entitlement to recover costs, the court noted that Anadarko's opposition to the recovery of costs incorrectly relief on the wrong statutory provision—*i.e.,* 12 O.S. § 942, which lists the costs the district court *may* award. The Venable defendants instead relied on section 1141.5(B) of the NMTPA which, as the more specific of the two costs statutes, controls. In the NMTPA, the legislature did not limit a successful

141. *Venable*, 368 P.3d at 4.
142. *Id*. at 5 (citing Head v. McCracken, 102 P.3d 670, 680-81 (Okla. 2004).
143. *Id*.
144. *Id*. (citing 12 O.S. § 1141.5(B)).

defendant to recovering only "costs." Rather, the legislature also authorized a successful defendant to recover the "actual expenses incurred" and the "expenses of litigation directly related to obtaining judgment."[145] As a result, the district court did not err in awarding the Venable defendants additional expenses not authorized as costs by 12 O.S. § 942.

The district court's award of attorney fees, costs and expenses to the Venable defendants was affirmed.

D. Court addresses dispute as to whether party seeking to enforce rights under Area of Mutual Interest (AMI) Agreement had already assigned away its rights in the subject property.

In *Burlington Resources Oil & Gas Company, LP v. Petromax Operating Co., Inc.*,[146] Burlington claimed an interest in certain leases and claimed rights in an Area of Mutual Interest. The Petromax defendants responded that Burlington no longer owned any interest in the AMI because it had previously executed a 1994 assignment that conveyed its rights in the AMI and subject leases to another party. Burlington countered that the assignment in question only conveyed Burlington's interest in 4 wells and reserved the remaining interests in the leasehold estates. The trial court granted summary judgment in favor of the Petromax defendants. Burlington appealed.

After reviewing the AMI provisions, conveyancing language and other terms of the series of contracts and assignments at issue, the Texas Court of Appeals found that the 1994 assignment was *unambiguous* and it affirmed the trial court's summary judgment decision in favor of Petromax. In reaching that outcome, certain of the more notable findings of the court were as follows:

Arguments based on custom in the industry and trade usage, as aids to contract construction, are not used unless a contract is ambiguous.[147]

A reservation of minerals to be effective must be by clear language. Courts do not favor reservations by implication.[148]

The practical distinction between a reservation and exception is questionable today, citing Williams & Meyers, Oil and Gas Law 336 (2008) (distinction between exceptions and reservations has lost most of its importance in contemporary law).[149]

145. *Id*. (citing 12 O.S. § 1141.5(B)).
146. 486 S.W.3d 703 (Tex. App. 2016).
147. *Id*. at 714.
148. *Id*.
149. *Id*. at fn. 9.

E. Texas Supreme Court Court reverses the 2014 Decision of the Court of Appeals which found that the subject assignment did not provide for "proportionate reduction" of a reserved production payment in the event of the expiration of 2 of the 4 underlying oil and gas leases.

In *McDaniel Partners, Ltd. v. Apache Deepwater, LLC*,[150] the dispute that was earlier presented to the Texas Court of Appeals involved a production payment reserved to the assignor under the terms of a 1953 assignment that covered 4 oil and gas leases. A parenthetical clause in the assignment described the manner of calculating the payment. The issue presented was whether the expiration of two of the four oil and gas leases should modify the manner of computing the production payment.

The precise language of the reserved production payment was as follows:

> "there is expressly excepted from this conveyance as a 'production payment interest,' the title to and ownership of . . . (1/16th of 35/64ths of 7/8ths, being one sixteenth of the entire interest in the production from said lands to which Assignor claims to be entitled under the terms of said respective oil and gas leases) of the total oil, gas, casinghead gas and other minerals in and under and which may be produced from the above described land, i.e., from each and both of said Surveys 36 and 37, Block 40, Township 5 South, T&P Ry. Co. Lands, until the net proceeds of said reserved interest . . ."[151] (Emphasis added by the court)

The 35/64 fraction represented the fact that the portion of the minerals attributable to each of the 4 leases at the time of the conveyance and reservation was as follows:

Cowden 36 lease: 16/64 of the total;

Cowden 37 lease: 16/64 of the total;

Peterman lease: 1/64 of the total; and

Broudy lease: 2/64 of the total.

In 1994, the Cowden 36 lease and Cowden 37 lease expired for lack of production. However, production continued as to the other 2 leases, with Apache commencing additional wells on those other leases.

150. 441 S.W.3d 530 (Tex. App. 2014).
151. *Id.* at 531-32.

Apache sent a Division Order to McDaniel showing that McDaniel was entitled to 1/16 of 3/64 of 7/8 of the production from the remaining 2 leases. McDaniel, in contrast, asserted that his production payment should continue to be computed as 1/16 of 35/64 of 7/8 of the production from the 2 remaining leases.

McDaniel sued Apache for breach of contract, conversion and for an accounting. At trial, neither party asserted that the subject assignment was ambiguous. The trial court found that the expiration of 2 of the original 4 leases should lead to a proportionate reduction of the production payment. McDaniel appealed.

In reversing the judgment of the trial court and ruling in favor of McDaniel, the 2014 decision of the Texas Court of Appeals found in part as follows:

The Texas Court of Appeals found that the single issue for review was whether the trial court correctly interpreted the production payment reservation under the 1953 Assignment. The appellate court concluded that the "exacting, 'longhand' description of the interest"[152] reserved unambiguously provided a precise fractional equation by which the production payment was to be computed: 1/16 of 35/64 of 7/8 of production. It was likewise unambiguous that the entire fractional equation was to be calculated against the total production from all of the lands.

The Texas Court of Appeals noted that the foregoing findings left the question of whether the terms of the assignment permitted a reduction of the production payment in the event any of the assigned leases expired. The parties and the court focused upon the following wording from the excerpt from the assignment quoted above: "(1/16th of 35/64ths of 7/8ths, being one sixteenth of the entire interest in the production from said lands to which Assignor claims to be entitled under the terms of said respective oil and gas leases)." Apache argued that this language explained how to compute the production payment at any particular point in time---*i.e.*, based on the amount of working interest acreage that is then attributable to the underlying leases.

The Texas Court of Appeals rejected Apache's contention and found that there was no language in the assignment providing for any adjustments, in the event of oil and gas lease termination, to either (a) the production payment's $3,550,000 dollar sum, or (b) the production payment's volumetric total of 1,420,000 barrels of oil. The court noted that if the parties had intended to periodically adjust the production payment, the

152. *Id.* at 535.

assignment surely would have included language providing for the adjustment of those numbers.

Finally, the Texas Court of Appeals observed that while certain legal scholars had opined that a production payment interest expires with the termination of the underlying oil and gas leases, it could find no prior Texas case deciding whether a production payment (absent express contractual language) can be proportionately reduced following the expiration of some, but not all, of the underlying leases.

In its 2016 decision in *Apache Deepwater, LLC v. McDaniel Partners, Ltd.*,[153] the Texas Supreme Court reversed the decision of the Court of Appeals and rendered judgment in favor of Apache. In doing so, some of the more notable findings of the court were as follows:

Ultimately, the nature of the particular production payment at issue here, and its burden on the underlying leasehold estates, rests on what the assignment says, not on what a party argues it should have said.[154]

Neither the inclusion of the four leases in a single instrument nor the instrument's statement of the leases' cumulative working interest as a single fraction demonstrates that the parties intended the production payment to be carved from something other than the estates conveyed. To the contrary, the explanatory phrase that follows the stated fraction ties the 1/16 reservation to the assignor's interest in the "respective" leases, indicating that the reserved interest pertains to the particular leases separately.[155]

Absent express language in the assignment to the contrary, we apply the general rule that "when an oil and gas lease terminates, the overriding royalty [or similar production payment] created in an assignment of the lease is likewise extinguished."[156] Applying that rule to the unambiguous language of this assignment, we conclude that the trial court rendered the correct judgment in the case.

The Texas Supreme Court reversed the Court of Appeals' judgment and rendered judgment that McDaniel take nothing.

153. 485 S.W.3d 900 (Tex. 2016).
154. *Id*. at 906.
155. *Id*. at 907.
156. Sunac Petroleum Corp. v. Parkes, 416 S.W.2d 798, 804 (Tex. 1967).

F. Court dismisses appeal, finding that the defendant's sale of the underlying oil and gas leases during the pendency of its appeal of a declaratory judgment ruling concerning alleged "free gas" rights of the plaintiff-landowner class rendered the appeal moot.

The events surrounding the appellate proceedings in *Schell v. OXY USA Inc.*[157] presented the not-uncommon situation of a litigant selling assets that are at issue in a lawsuit during the pendency of the litigation. The less-common aspect of the facts in this case, which led to a complex series of rulings by the Tenth Circuit, was that the only substantive judgment on appeal was a declaration as to the future rights and obligations of OXY relating to the assigned oil and gas leases, with no judgment for damages or other relief as to past actions of the defendant.

In this case, OXY appealed from the grant of summary judgment in favor of the plaintiff-landowner class "on the question of whether their oil and gas leases required OXY to make 'free gas' useable for domestic purposes."[158] OXY also appealed the district court's certification of the plaintiff class, the denial of OXY's motion to decertify the class and the district court's order quashing the deposition of an absent class member. The landowner class moved to dismiss the appeal as moot. OXY opposed dismissal based on mootness, and argued that if the court should find mootness, the court should vacate the district court's declaratory judgment in favor of the plaintiff class.

The underlying lawsuit was filed in 2007 by four oil and gas leaseholders on behalf of a proposed class seeking, among other relief, a declaratory judgment based on the alleged failure of OXY to supply free useable gas under the applicable oil and gas leases. The district court "certified a class of 'all surface owners of Kansas land burdened by oil and gas leases held or operated by OXY USA, Inc. which contain a free gas clause.'"[159] The plaintiffs ultimately sought only declaratory relief, and not damages for past time periods, when it became apparent that OXY had continued to provide free gas during prior periods so that the plaintiffs had no damage claims.[160] The district court granted the plaintiffs' motion for summary judgment and denied OXY's motion for summary judgment. Specifically, the court

157. 808 F.3d 443 (10th Cir. 2015).
158. *Id*. at 446.
159. *Id*. at 447-48.
160. *Id*. at 448.

granted the landowner plaintiffs "declaratory relief requiring OXY to provide free useable gas under the contract."[161]

OXY appealed the declaratory judgment of the district court. However, after filing the appeal, but before the appeal briefs were due, OXY sold all of its interests in the Kansas leases to Merit Hugoton, L.P. (Merit). In light of that sale, the plaintiffs moved the court to dismiss the appeal as moot.

The court allowed the appeal to proceed forward with briefing and oral argument. One week after oral argument, Merit filed a motion to intervene as an appellant. That motion was denied,[162] leaving the case presented for decision by the Tenth Circuit. The court began the ruling portion of its opinion with the holding:

> We conclude that this appeal is moot. OXY has sold all of its interests in the leases; therefore, its conduct cannot be affected by a declaratory judgment concerning these same oil and gas leases. Accordingly, we grant the motion of the plaintiff class to dismiss this appeal.

In reaching the above holding and other related rulings, some of the more notable issues and findings included the following:

The court noted that the doctrine of mootness, in the declaratory-judgment context, "looks to whether the requested relief will actually alter the future conduct of the named parties."[163] Citing a prior Tenth Circuit opinion, the court found that "[t]he crucial question is whether granting a present determination of the issues offered will have some effect in the real world." *Rio Grande Silvery Minnow*, 601 F.3d at 1110 (quoting *Wyoming v. U.S. Dep't of Agric.*, 414 F.3d 1207, 1212 (10th Cir.2005))."

Applying the above mootness principles to the facts of this case, the court found that

> the declaratory judgment at issue in this litigation—"that OXY is required to provide useable gas pursuant to the terms of the Free Gas Covenant without interruption," Aplt.App. at 795—cannot affect OXY's behavior because it is no longer bound by the leases and no longer operates the wells in question. OXY is

161. *Id*.

162. The court noted at various points in its opinion that the parties had declined to enter into the record any documents related to OXY's sale to Merit that might enable the court to know how a judgment against OXY might or might not be binding on Merit. Nor had either Merit or OXY petitioned for Merit to be substituted for OXY. The court found that there was no evidence in the record that a judgment against OXY would bind Merit. *Id*. at fn.4.

163. *Id*. at 449.

> completely unaffected by our interpretation of contractual provisions (*i.e.*, the free gas clauses) in contracts that no longer bind OXY.[164]

The court stated that OXY's only argument against mootness was that OXY continued to have an interest in the outcome of this lawsuit "due to the potential preclusive effects of the declaratory judgment."[165] The court stated that it regarded such concerns over "the effects of this judgment in hypothetical unfiled future litigation—to be not a legally cognizable interest that will defeat mootness."[166]

The court went on to observe that "[e]ven if OXY had breached the contracts in the past, our ruling today on the meaning of the free gas clauses cannot change its present behavior (because it no longer operates the wells) and cannot change its past behavior."[167]

Having determined that the appeal would be dismissed, the court next determined if it would grant OXY's request that, if the court were to dismiss the appeal over OXY's objections based on mootness, the court should then also vacate the district court's declaratory judgment in favor of the plaintiff class. The court noted that "when a case becomes moot on appeal, the ordinary course is to vacate the judgment below and remand with directions to dismiss."[168] However, when the appeal becomes moot as a result of "a voluntary act of one of the parties, we generally act to prevent a party from taking advantage of mootness that the party caused"[169] by refusing to vacate the district court's judgment. While those are the general practices, "[e]quitable principles keep us from applying this standard in a rigid fashion."[170]

In applying the principles recognized in its opinion, the court found that, after considering the equities in this case where OXY's voluntary action caused the appeal to be moot, vacating the district court's judgment would not be appropriate:

> OXY protests that it did not "enter[ ] into this $1.4 billion sale of regional assets for the purpose of mooting one appeal," . . . We cannot say that the fact that OXY may have undertaken a sale for

164. *Id*.
165. *Id*.
166. *Id*. at 449-50.
167. *Id*. at 451.
168. *Id*.
169. *Id*. at 452.
170. *Id*. at 453.

> other reasons requires us to "allow that party to eliminate its loss without an appeal and to deprive the winning party of the judicial protection it has fairly won."[171]

Accordingly, the Tenth Circuit dismissed the appeal without disturbing the district court's declaratory judgment.[172]

G. Texas Supreme Court determines that the requirement of "reasonable certainty of proof" applies even where lost profits are not sought as damages and are instead used to determine the market value of property for which recovery is sought, and court addresses formalities of contracting.

The Texas Court of Appeals' decision in the long-pending proceedings in *Phillips v. Carlton Energy Group, LLC*[173] was summarized in the 2012 edition of this annual report. Under the facts in this case, CBM Energy had entered into a contract with the government of Bulgaria in October of 2000 that permitted CBM to explore for natural gas on a large tract of land in Bulgaria. In order to obtain financing to fulfill its obligations under the Bulgarian concession, CBM entered into an agreement with Carlton on April 25, 2003, under which Carlton was to provide phased payments totaling $8 million in exchange for a large interest in the project. In an effort to obtain additional funding in the summer of 2004 to support its payment obligations, Carlton submitted a proposed agreement to Phillips under which Phillips would agree to pay $8.5 million in exchange for a 10% interest in the project. Ultimately, Phillips did not provide any funding to Carlton and Phillips later asserted that, contrary to Carlton's contentions, it never entered into a contract with Carlton. In particular, Phillips alleged that it signed the proposed letter agreement and returned it to Carlton for it to sign and accept. Phillips asserted that Carlton never returned to him a counterpart of the contract signed by Carlton.

Carlton later learned that in the Fall of 2004, during the period when Carlton was providing Phillips with technical data concerning the project during their negotiations, "Phillips and his representatives, without Carlton's knowledge, were in direct contact with CBM about the Bulgaria Project."[174] Carlton alleged that Phillips was taking action to supplant

171. *Id.* at 456-57 (citing Mfrs. Hanover Trust Co. v. Yanakas, 11 F.3d 381, 383. (2d Cir. 1993).

172. The court does state in footnote 10 of its opinion that its decision to not vacate the district court's judgment "should not be read as an affirmance of the underlying decisions on the merits." *Id.* at fn. 10.

173. 369 S.W.3d 433, 440 (Tex. App. 2012).

174. *Id*. at 440.

Carlton's position with CBM in relation to the project. In February 2005, EurEnergy, a company connected to Phillips, made a proposal to CBM and then entered into a joint development agreement under which EurEnergy provided funding to CBM for the project. As part of that contract, CBM agreed to declare Carlton in default of its obligations under the CBM/Carlton contract, and Carlton did so. "CBM and EurEnergy's relationship subsequently soured, and litigation between CBM and EurEnergy ensued."[175] Bulgaria thereafter terminated the concession it had granted to CBM.

Based on the complex factual history described in the court's opinion, Carlton sued Phillips, EurEnergy and several other Phillips-related entities for tortious interference with the CBM/Carlton agreement, and for breach of contract and related claims. After a lengthy trial, the jury found that Phillips did in fact enter into a contract with Carlton and breached that contract. The jury awarded actual damages in the amount of $66.5 million. The jury further found that Phillips and EurEnergy intentionally interfered with the CBM/Carlton agreement, and that Carlton suffered $66.5 million in actual damages on that claim. The jury also awarded $8.5 million in punitive damages against Phillips and awarded the same amount against EurEnergy. The trial court, *sua sponte*, suggested a remittitur in the amount of $31.16 million, finding that the award of $66.5 million in actual damages was not supported by factually-sufficient evidence. The court, in its judgment on the jury verdict, awarded Carlton the reduced amount of $31.16 million in actual damages. The judgment assessed punitive damages in the amount of $8.5 million against Phillips, with the same award against EurEnergy. The defendants appealed.

In reversing the judgment of the trial court in part, the court of appeals first concluded that Carlton had submitted ample evidence to support the jury's conclusions with respect to the tortious interference claim. The court of appeals found that the trial court erred in requiring a remittitur from $66.5 million to $31.16 million. So it "rendered judgment on the verdict, awarding Carlton the $66.5 million actual damages found by the jury,"[176] together with exemplary damages.

The Texas Supreme Court in *Phillips v. Carlton Energy Group, LLC*,[177] affirmed in part and reversed in part the judgment of the court of appeals. In

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175. *Id*.
176. Phillips v. Carlton Energy Group, LLC, 475 S.W.3d 265, 275 (Tex. 2015).
177. *Id*.

reaching that outcome, some of the more significant rulings of the court included the following:

Phillips emphasized on appeal on the lack of evidence that Carlton ever signed and returned to Phillips' the modified version of the contract that Phillips returned to Carlton as Phillips' counter-offer. Phillips contended that Carlton's failure to sign and return the revised version of the proposed agreement meant that there was no binding contract, contrary to the finding of the jury. The court noted that, in the weeks that followed Phillips' counter-offer to Carlton, both parties behaved in certain respects as if they had an agreement, although the court recognized that certain aspects of the parties' conduct also suggested that they had not entered into a contract. Moreover, the court cited its prior holding that signature and delivery are not essential elements for the formation of a contract:

> Texas law recognizes that a contract need not be signed to be "executed" unless the parties explicitly require signatures as a condition of mutual assent. If a written draft of an agreement is prepared, submitted to both parties, and each of them expresses his unconditional assent thereto, there is a written contract.[178]

The court found that the evidence supported the jury's finding that a contract was formed.

The court additionally discussed the rule in Texas that lost profits can be recovered as consequential damages only when the amount is proved with reasonable certainty.[179] However, it found that the court had never spoken to the issue of whether the

> requirement of reasonable certainty of proof should apply when lost profits are not sought as damages themselves but are used to determine the market value of property for which recovery is sought.[180]

Finding that the purpose of the rule is to prevent recovery based on speculation, the court concluded that it would make no sense to *not* apply the rule in these circumstances. It observed that the "law is wisely skeptical of claims of lost profits from untested ventures or in unpredictable circumstances, which in reality are little more than wishful thinking."[181]

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178. *Id*. at 277 (quoting Mid–Continent Cas. Co. v. Global Enercom Mgmt., Inc., 323 S.W.3d 151, 157 (Tex.2010)).

179. *Id.* at 278.

180. *Id.* at 279.

181. *Id.* at 280.

However, it added that the law should "be no more skeptical of claimed market losses than the market itself is."[182]

The judgment of the court of appeals was affirmed in part and reversed in part, and the case was remanded for further proceedings, including a determination of damages in a manner consistent with the court's opinion.

On remand to the Texas Court of Appeals in *Carlton Energy Group, LLC v. Phillips*,[183] that court reviewed the evidence presented at trial and concluded "that the evidence supporting the trial court's award of $31.16 million in actual damages to Carlton, as the fair market value of its interest in the Bulgaria Project at the time that Phillips and EurEnergy tortiously interfered with the CBM/Carlton agreement, is not so weak as to render the award clearly wrong and manifestly unjust."[184] The court held that the evidence was factually sufficient to support the trial court's award to Carlton of $31.16 million in actual damages against Phillips and the Phillips entities.

V. Marketing and Refining of Oil and Gas Production

A. Court determines whether natural gas in storage constituted "goods, wares, and merchandise" for purposes of ad valorem tax exemption.

The case of *Missouri Gas Energy v. Grant County Assessor*,[185] the dispositive issue presented was "whether natural gas ('gas') in storage constitutes 'goods, wares, and merchandise' for purposes of the Freeport Exemption, Okla. Const. art. X, §6A; or, alternatively, whether the gas allocated to [Missouri Gas] for taxation purposes has a taxable situs in Oklahoma as required by 68 O.S. §2831."[186]

The appellant Missouri Gas Energy (MGE) is a local distribution company with its headquarters in Kansas City, Missouri. MGE purchases gas from suppliers and transports the gas via interstate pipeline for resale to its customers in Missouri. MGE entered into gas transportation and storage contracts with Southern Star, an interstate pipeline company based in Kentucky and regulated by the Federal Energy Regulatory Commission. Southern Star's pipeline system extended across Texas, Oklahoma, Kansas,

182. *Id.* The court drew an analogy to lottery tickets: "The prospect of winning millions in the lottery is too small to support any award of potential proceeds for, say, theft of a ticket; still the ticket itself has some value—the price it commands on the market." *Id.*

183. No. 01-09-00997-CV, 2016 WL 4536284 (Tex. App. Aug. 30, 2016).

184. *Id*. at *14.

185. 376 P.3d 923 (Okla. Civ. App. 2016).

186. *Id*. at 924.

Missouri, Nebraska, Colorado and Wyoming. MGE purchases gas from suppliers and then nominates the purchased volumes of gas for receipt into the Southern Star pipeline system at various pooling points. Depending upon the type of nomination, made, Southern Star would either transport the gas to MGE‘s delivery points in Missouri, or would credit the gas to MGE's system wide gas storage account. All of MGE's gas is sold to customers in Missouri. MGE does not sell gas, and has no employees, in Oklahoma.[187]

Southern Star also owns and operates 8 underground storage facilities connected to its pipeline. One such storage facility is located in Grant County, Oklahoma (the "Grant Facility"). MGE asserted that the gas injected at the Grant Facility enters the Southern Star pipeline system at meter points in Wyoming, Colorado, Kansas, Texas and Oklahoma. MGE contended that the gas stored at the Grant Facility did not all physically originate in Oklahoma. While Southern Star has possession of the gas in storage at the Grant Facility, title to the gas remained with its customers, including MGE.

For ad valorem tax purposes, Southern Star allocates a volume of gas stored at the Grant Facility as of January 1 of each calendar year to each of its customers, including MGE. Copies of the allocations are provided to the Grant County Assessor who then assesses personal property ad valorem taxes against the allocated storage volumes. For tax year 2011, MGE received its Grant Facility allocation and timely filed a Freeport Exemption Declaration for the portion of the gas allocated to it which MGE claimed did not originate in Oklahoma. The Grant County Assessor and Board of Equalization each denied the claimed exemption. MGE filed an appeal to the district court arguing that the gas allocated to it which did not originate in Oklahoma did not have a taxable situs in Oklahoma as required by 68 O.S. § 2831. The district court entered summary judgment in favor of the Grant County Assessor and Board of Equalization. That court found that the Freeport Exemption[188] did not apply to natural gas in storage "because it is not included in the category of 'goods, wares and merchandise' for purposes of the Freeport Exemption,"[189] and the district court further found that the gas had a taxable situs in Oklahoma. MGE appealed.

187. *Id.*
188. OKLA. CONST. ART. X, §6A.
189. *Missouri Gas Energy*, 376 P.3d at 925.

In reversing in part and affirming in part the decisions below, some of the more notable rulings of the Oklahoma Court of Appeals were as follows:

Under Oklahoma law, "[a]ll property in this state, whether real or personal, except that which is specifically exempt by law . . . shall be subject to ad valorem taxation. 68 O.S. §2804. Article X, §6A of the Oklahoma Constitution, commonly referred to as the 'Freeport Exemption' provides in part:

> provided, that goods, wares and merchandise, whether or not moving on through rates, shall be deemed to move in interstate commerce, and not subject to taxation in this State if not detained more than nine (9) months where such goods, wares and merchandise are so held for assembly, storage, manufacturing, processing or fabricating purposes . . .[190]

After analyzing the wording of the exemption in depth, the court noted that during the pendency of the case, the Legislature changed the definition of personal property for purposes of ad valorem taxation through the enactment of House Bill 1962, 2015 Okla. Sess. Law Ch. 262, §1 (codified at 68 O.S. § 2807) (effective May 6, 2015). The Legislature provided that the amended wording—which was favorable to the position of MGE in this appeal—was to be given both retrospective and prospective effect. The court concluded that "natural gas severed from the realty qualifies as 'goods, wares, and merchandise' for purposes of the Freeport Exemption." The decision of the trial court was reversed and remanded on that issue.

As to MGE's argument that gas allocated to it which did not originate in Oklahoma could not have a taxable situs in the state as required by 68 O.S. § 2831, the court found that the fact that the gas at issue here—which was stored at the Grant facility for approximately 9 months—had a taxable situs in Oklahoma regardless of where the gas originated. Thus, <u>if</u> the Freeport Exemption did not apply in this case, the gas would be taxable in Oklahoma. The court remanded the case to the trial court to determine the amount of gas which is exempt from ad valorem taxation due to the Freeport Exemption (*i.e.*, to determine the amount of gas which MGE claims originated outside of Oklahoma, whether such gas was stored in Oklahoma for nine months or leass, and the amount of that gas which was shipped and sold outside of Oklahoma for Tax Year 2011).[191]

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190. *Id*. at 926.
191. *Id*. at 929.

B. Debtor in bankruptcy is allowed to reject executory gas gathering contracts which were found to not be covenants running with the land.

On March 8, 2016, the U.S. Bankruptcy Court for the Southern District of New York issued its initial highly controversial decision in *In re: Sabine Oil & Gas Corporation*,[192] which allowed a debtor in bankruptcy to reject certain gas gathering contracts covering Texas oil and gas properties. That decision was followed by the Court's further formal and binding ruling on May 3, 2016.[193]

The court found that the gas gathering agreements did not convey an interest in real property, did not touch and concern real property, and did not run with the land under Texas law. Consequently, the debtor was allowed to reject the contracts so that it could replace the gathering agreements with new contracts containing commercial terms more favorable to the debtor.

Since the time these decisions were issued, there has been a proliferation of writings and seminar talks devoted to the analysis and future import of the *Sabine* rulings. Accordingly, given the broader role of this paper and presentation as being one that focuses on the coverage of a variety of legal developments, the broader discussion and analysis of these highly publicized rulings will be left to the many commentaries that are available online.[194]

C. District court adopts bankruptcy court's proposed findings and conclusions in support of granting the downstream crude oil purchasers' motion for summary judgment against lien claims and other assertions of the oil producers.

In *In re SemCrude, L.P.*,[195] the court was presented with a dispute between a group of oil producers (Producers) that had sold oil to the debtor in bankruptcy (SemCrude, L.P.) and two downstream purchasers, J. Aaron & Company and BP Oil Supply Company (Purchasers). The Purchasers filed adversary proceedings in SemCrude's chapter 11 bankruptcy case

192. 547 B.R. 66 (Bankr. S.D.N.Y. 2016).

193. In re Sabine Oil & Gas Corp., 550 B.R. 59 (Bankr. S.D.N.Y. 2016).

194. .See, *e.g.*, http://us.practicallaw.com/w-002-2648; https://www.reedsmith.com/Decisions-in-Sabine-Oil--Gas-and-Quicksilver-Resources-Inc-Bankruptcy-Cases-Will-Have-Broad-Impact-on-Midstream-and-Exploration--Production-Companies-in-the-Oil--Gas-Industry-03-09-2016/; http://www.kslaw.com/library/publication/ca030816b.pdf; http://www.sidley.com/news/05-04-2016-energy-update.

195. No. 08-11525, 2015 WL 4594516 (D. Del. July 30, 2015).

seeking declaratory relief with respect to both the Purchasers' rights in certain disputed oil production and the Purchasers' obligations, if any, to the Producers. Before the federal district court in this case were the bankruptcy court's proposed findings of fact and conclusions of law (FFCL). The bankruptcy court recommended the granting of summary judgment in favor of the Purchase on all counts in their adversary complaints. The Producers filed objections to the proposed FFCL, and the Purchasers responded, such that the proposed FFCL were before the court in this cause for the entry of a final judgment.

The factual backdrop for the claims involved the July 22, 2008, filing by SemCrude and related entities of voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code. The Semcrude debtors provided midstream services in the oil and gas industry, "primarily aggregating oil and gas from producers and reselling the product to downstream purchasers."[196] J. Aron & Company was "a commodities trading company that not only purchased physical oil from the Debtors, but also traded financial derivatives with them."[197] For purposes of the disputes presented in this case, the court found that BP Oil Supply Company's "relationship with the Debtors was functionally equivalent to that of J. Aron's."[198]

At the time the SemCrude debtors filed bankruptcy, "they had not yet paid the Producers for oil they purchased on credit in June and July of 2008."[199] Thousands of oil producers filed claims in the SemCrude bankruptcy proceedings with respect to the oil they delivered, but were not paid for, during the 51 days prior to the bankruptcy filing. The Producers also asserted claims against the Purchasers who had received the oil delivered to SemCrude by the Producers during the 51-day period for which no payment had ever been made to the Producers. The Purchasers filed adversary proceedings seeking, among other relief, a declaratory judgment that the Purchasers' proposed tender of some $122 million (proposed to be the *final net amount* they owed the SemCrude debtors under their agreements) "fully satisfied and released the Purchasers from any claims of the Debtors and the Producers in the disputed oil."[200]

On June 28, 2013, the bankruptcy court issued its proposed FFCL and recommended the granting of summary judgment in favor of the

196. *Id*. at *2.
197. *Id*.
198. *Id*. at *3.
199. *Id*.
200. *Id*. at *4.

Purchasers. The Producers objected to many of the findings proposed by the bankruptcy court. In this phase of the litigation, the federal district court reviewed the proposed findings and the Producers' objections. Among the many issues addressed by the Court, several of the more interesting findings included the following:

With regard to the Purchasers' objection to the bankruptcy court's proposed finding "that the Purchasers took the disputed oil free and clear of all liens as buyers for value (BFV) under § 9-317 of the Uniform Commercial Code,"[201] the district court first considered the proposed finding that the Producers' purported lien rights were unperfected. The court noted that "certain U.C.C. provisions specific to Kansas and Texas provide [Producers] with automatically perfected liens in the oil they delivered to the Debtors."[202] However, the court concluded that the varying perfection laws among the states did not make a difference because, under Delaware law (the state of formation of the debtors), "the jurisdiction in which a debtor is located governs the issue of perfection."[203] From that finding, the court concluded that the Producers could not take advantage of the automatic perfection provisions of certain other states.

The Producers also challenged the bankruptcy court's recommendation that the court find, as to the BFV defense, that the Purchasers did not take the oil with actual knowledge of the Producers' liens. The Producers alleged that the following circumstantial evidence created disputed issues of fact as to this defense:

> (a) the Purchasers knew that the Debtors purchased oil in Kansas, Texas, and Oklahoma; (b) the Purchasers knew the identities of some of the specific Producers; (c) the Purchasers knew that the laws of certain producer states automatically encumbered the proceeds of oil sales; and (d) the Purchasers knew that Debtors did not pay for the oil [but instead purchased the oil on credit].[204]

The court found that the Producers' contention that the Purchasers had actual knowledge of their liens "rests solely upon general knowledge of the industry; knowledge of the parties, knowledge of those parties' locations, and knowledge of the applicable laws."[205] The court found that this was

201. *Id*. at *8
202. *Id*.
203. *Id*.
204. *Id*. at *10.
205. *Id*.

insufficient to establish the Purchasers' *actual knowledge* of a lien under § 1-202(b) of the Uniform Commercial Code (UCC).

With respect to the bankruptcy court's proposed finding that the Purchasers also acquired the Producers' oil free and clear of any liens as buyers in the ordinary course of business (BIOC) under §9-320(a) of the UCC, the Producers asserted that the crude oil purchase contracts of J. Aron were with the parent entity SemGroup, rather than with SemCrude. The Producers asserted that a parent or holding company does not buy or sell oil in the ordinary course of business, so that the proposed finding of the court was in error. The district court stated that it

> "rejects this formalistic approach. . . [C]ontrary to the Producers' suggestion, the 'person' who sells the goods in the ordinary course of business is not necessarily limited to the unitary legal entities that are parties to the transaction"[206]

It added that SemGroup owned 99.5% of the equity in SemCrude and ultimately received the value of the crude oil sales at issue in this suit. Consequently, in spite of the formal legal distinction between the two entities, the UCC's definition of "person" for purposes of the BIOC defense was found to be broad enough to encompass the SemGroup-SemCrude relationship.

VI. Surface Use, Surface Damages, Oklahoma Surface Damages Act, Condemnation and Environmental Cases

A. Seller of property seeks to rescind the transaction after learning that the buyer would be using the land for a disposal well.

The case of *Stinson Farm and Ranch, L.L.C. v. Overflow Energy, L.L.C.*,[207] involved a suit by the plaintiff-seller of land to obtain rescission of the sale and transfer documents based on the defendant-buyer's alleged misrepresentation that it was buying the property for use as an equipment yard. Less than a year after the sale, the seller learned that the defendant had applied for a commercial disposal well permit several weeks after the closing of the sale.

In rejecting the request for rescission based upon alleged fraud, the court ruled that the seller could not simply inquire in discussions with the buyer about the intended usage, even on more than one occasion, and then seek to

206. *Id*. at *11.

207. No. CIV-14-1400-R, 2015 WL 4925921 (W.D. Okla. Aug. 18, 2015).

rely on the buyer's response without seeking to protect the seller by affirmatively stating in the sale documents that the property would not be used for certain specified offensive purposes. The court further noted that there was no evidence that the buyer did not actually intend at the time of the earlier discussions to build an equipment yard on the property other than the fact that the buyer did not do so.

B. Court holds that the "public purpose" requirement for the exercise of the right of condemnation does not require that the primary intended beneficiaries of the taking be residents of the state.

The case of *AEP Oklahoma Transmission Company, Inc. v. Wooten*,[208] was an action by AEP to acquire by eminent domain an easement to construct and operate an interstate electric transmission line over the property of Wooten. In appealing the trial court's judgment in favor of AEP, Wooten asserted that the "taking" in this was not shown by AEP to be necessary for a legitimate *public purpose* under Oklahoma law. In particular, the landowner argued that prior case law[209] held that, in order for a public purpose to be involved, the primary intended beneficiary of the use of the property must be the Oklahoma public. Wooten asserted that AEP's transmission line would primarily benefit residents of Texas.

The court rejected that argument and found that there is no requirement that the primary intended beneficiaries be Oklahoma residents.[210]

C. Court rejects claim that the well operator, for whom the electric utility company entered landowners' property to lay an electrical line, was an "aider and abetter" of the utility company's alleged trespass.

The case of *Buckles v. Triad Energy, Inc.*,[211] involved the construction by OG&E (an electric utility) of an electrical highline to supply electricity to a well operated by Triad. The plaintiff landowners objected to the fact that the electrical supply line ran across public right-of-way including their lands in Section 28 in order to supply electricity to a well in Section 22. The landowners did not sue the utility, OG&E. Instead, they sued the operator

208. 86 OBJ 2698 (Okla. App. 2015 - #113,641) (Not for Publication).

209. Board of County Comm'rs v. Lowery, 136 P.3d 639 (Okla. 2006).

210. The court held that the *Lowery* case did not establish such a test, and further stated that the panel disagreed with the opinion in Okla. Gas & Elec. Co. v. Beecher, 256 P.3d 1008, to the extent that it viewed the *Lowery* decision as the key factor in determining whether a public use is present is whether the primary intended beneficiaries are the Oklahoma public.

211. 364 P.3d 665 (Okla. Civ. App. 2015).

Triad as an alleged aider and abetter of trespass in the construction of the line. Triad responded that it did not own, operate or maintain the supply line and did not construct it. Rather, Triad was merely a customer of OG&E, which had the right to use the right-of-way as a public utility.

The court of appeals found that the legal authority relied upon by the landowner "provides no support for the proposition a customer of a public utility is liable as an aider and abettor simply by requesting the provision of electrical service by a public utility."[212] The court further rejected the landowner's assertion that this case involved a "private use" for a single oil and gas well of the public's right-of-way, noting that the undisputed evidence showed that the highline was not only allowed to, but actually did, provide service to more than one customer. The court of appeals affirmed the district court's ruling in favor of the operator Triad, finding that the landowner had not stated a legally cognizable claim against Triad for aiding and abetting a trespass.

D. Court addresses claims of error in the proceedings below under the Surface Damages Act.

The court in *Xanadu Exploration Co. v. Welch*[213] addressed claims under the Oklahoma Surface Damages Act.[214] The court (1) found that the trial court did not err in instructing the appraisers to determine the diminished value of the *entire* tract owned by the landowners resulting from the drilling operations, as opposed to only the lands actually used and occupied, (2) agreed with the Operator that the appraisers' report was flawed in that it did not describe the quantity, boundaries and value of the property entered on or to be utilized in the drilling operations, as required by 52 O.S. § 318.5(C), and (3) ruled that the appraisers had "no authority to direct mitigation, but may award the cost to restore land to its former condition, with compensation for loss of use of it, only if this cost is less than the diminution in fair market value of the land."[215]

E. Appeal of rulings under Surface Damages Act was found to be premature.

The case of *Veteran Exploration & Production, LLC v. McCraw*[216] involved the court's careful review of the various steps to be followed by

212. *Id*. at 672.
213. 362 P.3d 237 (Okla. Civ. App. 2015).
214. 52 O.S. §§ 318.2-318.9.
215. *Xanadu*, 362 P.3d at 241.
216. 358 P.3d 958 (Okla. Civ. App. 2015)

the parties and the Court Clerk's office in connection with a lawsuit under the Oklahoma Surface Damages Act. The court concluded that the incomplete proceedings below did not lead to a *final* order, so the appeal was dismissed as premature and the case was remanded for further proceedings.

F. Court resolves dispute under agricultural surface lease as to the allocation of surface damages payments between lessor and agricultural tenant.

The plaintiff in *Hoffman v. Jones, as Co-Trustee of the Clyde Hansen Testamentary Trust*[217] entered into to a written lease with the Hansen Trust covering the use of the surface of certain lands for agricultural purposes. The lease provided that Hoffman was to receive a share of payments which the Hansen Trust was paid for damages caused by oil and gas exploration or by the placement of a pipeline on the leased property. After exploration activities were conducted, a pipeline was laid and the Trust received money from the exploration activities and pipeline installation. When a disagreement arose as to Hoffman's entitlement to a share of the money, Hoffman sued the Trust claiming entitlement to 25% of $7,522.00 paid for seismic operations and 40% of $103,986.00 paid to the Trust in connection with a pipeline right-of-way across land covered by Hoffman's lease. The trial court found that both Hoffman and the Trust had reached settlements and accepted payments from the pipeline company. On that basis, the court concluded that Hoffman was not entitled to any of the money the Trust received for the pipeline right-of-way. However, the trial court ruled that Hoffman was entitled to 25% of the $7,522.00 the Trust received in connection with the seismic operations.

On appeal, the Trust asserted that the lease agreement only entitled Hoffman to receive 25% of any "damages" caused as the result of oil and gas exploration on the lease, and that the $7,522.00 was paid for the "right to conduct" seismic activities and not for any damages caused. However, the Court of Appeals noted that Hoffman testified at trial regarding the damages caused by the seismic operations, including the disturbance to his quiet enjoyment of the leasehold. That testimony was found to be competent evidence to support the trial court's ruling on this claim, and the ruling was affirmed.

217. 86 O.B.J. 2294 (Okla. App. 2015 - #112,846) (Not for Publication).

G. In a case of first impression, the Texas Supreme Court holds that Texas' accommodation doctrine applies to the relationship between the owner of the severed groundwater estate and the surface estate.

In *Coyote Lake Ranch, LLC v. City of Lubbock*,[218] the plaintiff Ranch had previously deeded its groundwater to the City of Lubbock, reserving water for domestic use, ranching operations, oil and gas production, and agricultural irrigation. For irrigation, the deed allowed the Ranch to drill only one or two wells in each of 16 specified areas. The deed contained lengthy and detailed provisions regarding the City's right to use the land. At the time of the litigation, 18 wells had been drilled on the Ranch for irrigation or domestic use, and the City had drilled 11 wells on the northern edge of the Ranch.

In 2012, the City announced plans to increase water extraction efforts on the Ranch, possibly drilling as many as 20 test wells in the middle of the Ranch, followed by 60 additional wells spread across the Ranch. The Ranch objected that the proposed drilling program would increase erosion and injure the surface unnecessarily. The City argued that it was acting well within the broad rights granted by the Ranch in its deed of water rights. The Ranch sued to enjoin the City from proceeding.

The Ranch pleaded in part that the City had a contractual and common law responsibility to sue only that amount of surface that was reasonably necessary to its operations, and that the City had a duty to conduct its operations with due regard for the rights of the surface owner. The City responded that it had full rights under its deed to pursue its plans and that the law imposed no duty on groundwater owners, as it does on mineral owners, to accommodate the surface owner.

At the hearing on the Ranch's request that the City be enjoined from proceeding, the Ranch presented testimony as to damage that would be caused by the City's planned course of action and presented a proposed alternative plan for different well cites and fewer roads. The trial court granted the Ranch a temporary injunction. The City appealed. The Texas Court of Appeals found that the accommodation doctrine did not apply to groundwater interests and reversed the trial court's grant of relief to the Ranch.

In ruling in favor of the Ranch, t he Texas Supreme Court concluded that the City was in error in its contention that the deed provisions alone determined its rights to use the Ranch:

218. 498 S.W.3d 53 (Tex. 2016).

> The accommodation doctrine, based on the principle that conflicting estates should act with due regard for each other's rights, has provided a sound and workable basis for resolving conflicts between ownership interests. The paucity of reported cases applying the doctrine suggests that it is well-understood and not often disputed. We have applied the doctrine only when mineral interests are involved. But similarities between mineral and groundwater estates, as well as in their conflicts with surface estates, persuade us to extend the accommodation doctrine to groundwater interests.[219]
>
> Accordingly, we hold that the accommodation doctrine applies to resolve conflicts between a severed groundwater estate and the surface estate that are not governed by the express terms of the parties' agreement. As stated in Merriman, the surface owner must prove that (1) the groundwater owner's use of the surface completely precludes or substantially impairs the existing use, (2) the surface owner has no available, reasonable alternative to continue the existing use, and (3) given the particular circumstances, the groundwater owner has available reasonable, customary, and industry-accepted methods to access and produce the water and allow continuation of the surface owner's existing use.[220]

The Court of Appeals judgment reversing the temporary injunction and remanding the case for further proceedings was affirmed.

VII. Litigation Involving International Energy and Resources and Operations

A. Motion to dismiss suit filed in the U.S. courts between foreign governments, involving dispute over stored crude oil, is granted in part and denied in part.

The case of *Ministry of Oil of the Republic of Iraq v. 1,032,212 Barrels of Crude Oil Aboard the United Kalavrvta*[221] presented the court with "a dispute between Iraq and the Kurdistan region of Iraq as to the ownership of more than one million barrels of crude oil."[222] The oil had been held in

219. *Id*. at 63.
220. *Id*. at 64-65.
221. No. G-14-249, 2015 WL 93900 (S.D. Tex. Jan. 7, 2015).
222. *Id*. at *1.

storage aboard a tanker near the coast of Galveston, Texas since July 2014. The Ministry of Oil of the Republic of Iraq (MoO) filed a complaint asking the court to seize the oil from the tanker on the grounds that the oil was the property of Iraq and had been converted by the Ministry of Natural Resources of the Kurdistan Regional Government of Iraq (KRG). The court granted a seizure order, and "a warrant issued to be executed once the tanker entered United States ('U.S.') waters."[223] The KRG moved the court to vacate the seizure order. The court dismissed the MoO's action without prejudice, finding that it lacked jurisdiction, and vacated the seizure order. In response, the MoO filed its second amended complaint, and KRG filed another motion to dismiss which is the subject of the present decision of the court.

In granting the motion to dismiss in part and denying it in part, the court ruled in primary part as follows:

The court first considered the political question doctrine which "excludes from judicial review those controversies which revolve around policy choices and value determinations constitutionally committed for resolution to the halls of Congress or the confines of the Executive Branch."[224] It found that the claims presented in this suit "seek an interpretation of the text of the Iraqi Constitution and application of that interpretation to the facts of the case to determine if the oil was converted."[225] Those issues were found to involve classic judiciary functions rather than political questions, so the court denied the motion to dismiss the amended complaint based on the political question doctrine.

The next issue considered by the court was whether the MoO's claims should be dismissed under the Foreign Sovereign Immunities Act (FSIA),[226] which provides foreign states with immunity from suit in U.S. courts, subject to certain exceptions. Here, the exception alleged to apply to the actions of KRG was the commercial activities exception:

> The activity complained of is the taking of Iraqi oil for sale, there are specific allegations that it has been sold in the U.S., and the sale of oil in the U.S. creates a direct effect in the U.S.[227]

223. *Id.*
224. *Id.* at *2 (quoting Japan Whaling Ass'n v. Am. Cetacean Society, 476 U.S. 221, 230 (1986)).
225. *Id*. at *7.
226. 28 U.S.C. § 1604.
227. *Ministry of Oil of the Republic of Iraq*, 2015 WL 93900 at *10.

The court found that the commercial activities exception of the FSIA applies under the facts of this case and therefore denied KRG's motion to dismiss under the FSIA.

The court next found that admiralty jurisdiction did not exist, noting that the sale and conversion of oil can occur anywhere and does not traditionally occur only on the water. Thus, the motion to dismiss on the basis that the court lacked admiralty jurisdiction was granted.

Finally, in assessing the act of state doctrine, the court recognized that this doctrine provides that "the courts of one country will not sit in judgment of the acts of another, done within its own territory."[228] However, in the present case, the government of Iraq itself sought out the United States courts, and it only brought suit in the U.S. after attempting without success to resolve the case in Iraqi courts. The court denied KRG's motion to dismiss on the basis of the act of state doctrine.

B. Court confirms the award of an International Court of Arbitration panel in a dispute among the participants in a joint venture involving the construction, ownership, supply and operations of crude oil refining facilities.

The case of *PDV Sweeny, Inc. v. ConocoPhillips Co.*,[229] presented a petition to vacate, and a cross-petition to confirm and enforce, an arbitration award issued by an International Court of Arbitration panel. The underlying facts involved a number of entities and "a complex web of agreements governing the supply and management of the oil refining operation"[230] at issue in the arbitration.

> ConocoPhillips, PDVSA and their respective subsidiaries commenced a joint venture to design, construct, own, supply, and operate refining facilities within the broader confines of a large refining complex owned by ConocoPhillips in Texas . . . PDVSA and its affiliates supplied crude oil from Venezuela which was then processed by ConocoPhillips.[231]

Through the venture, PDVSA benefited from the greater refining and operational expertise of ConocoPhillips, and ConocoPhillips "was able to

228. *Id.* at *12 (quoting Spectrum Stores, Inc. v. Citgo Petroleum Corp., 632 F.3d 938, 954 (5th Cir. 2011)).

229. No. 14-cv-5183 (AJN), 2015 WL 5144023 (S.D.N.Y. Sep. 1, 2015).

230. *Id.* at *1.

231. *Id*.

secure a long-term, low cost source of crude oil from Venezuela, which it was then able to convert into high-value end products."[232]

Among the many contracts that were a part of the venture and its operations, the agreement most directly at issue in the arbitration was a Transfer Agreement, governed by New York law, which restricted the manner in which the parties could transfer their interests in the joint venture. The Transfer Agreement included a Call Option which could be triggered if a PDVSA subsidiary failed to meet its obligation to supply crude oil under the parties' supply contract, or failed to make payments due under a supplemental contract, and the failure(s) remained uncured for 90 days. If the Call Option was exercised, the exercising party was allowed to acquire all of the joint venture interest of the other party. However, the exercise of the Call Option did not automatically trigger a dissolution of the crude oil supply agreements. Rather, PDVSA and its affiliates would still be required to supply Venezuelan crude oil to ConcoPhillips even if they no longer owned an interest in the joint venture.

When the PDVSA parties curtailed their supply of crude oil in January 2009, allegedly due to cutbacks in the production and export of crude oil from Venezuela, ConocoPhillips ultimately exercised the Call Option. To acquire the PDVSA share of the joint venture under the exercised option, ConocoPhillips was required to pay "eighty percent of the PDVSA parties' capital contributions to the joint venture minus all capital distributions from the joint venture to the PDVSA parties."[233] Since the PDVSA parties had received capital distributions totaling over $1.1 billion, and had made capital contributions of only some $270 million, the option price formula resulted in a purchase price of zero dollars.[234] Since the crude oil supply agreements remained in place, PDVSA and its affiliates resumed shipments of oil in October 2009.

The PDVSA parties commenced arbitration under the ICC Rules of Arbitration in February 2010. Among multiple issues raised, the PDVSA parties "challenged the validity of the Call Option, alleging that it acted as an unenforceable penalty clause under New York contract law . . . because it resulted in a purchase price of zero dollars for their share of the joint venture,"[235] which was estimated to have a value between $352 million and

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232. *Id.*

233. *Id.* at *3.

234. ConocoPhillips was also required to assumed outstanding debt obligations of the PDVSA parties in the amount of approximately $195 million. *Id.*

235. *PDV Sweeny*, 2015 WL 5144023 at *3.

$540 million.[236] They asserted that the purpose of the Call Option was to compel their performance rather than provide ConocoPhillips with adequate damages. The arbitration Panel issued its Award, finding “that the Call Option was valid and enforceable under New York law and could not constitute an impermissible contractual penalty.”[237] In the view of the Panel, the Call Option was a valid contract provision for the termination of the joint venture, and was not a liquidated damages or penalty clause.

In the present federal district court proceedings, the PDVSA parties asked the court to vacate the portion of the Award described above on the grounds that it violated the public policy of New York and the United states. ConocoPhillips, in turn, asked the court to confirm and enforce the Award. The court first considered the two international conventions relating to the enforcement of arbitration awards of the type at issue in this case and concluded that it had jurisdiction over the matters presented. The court then analyzed the complex body of law that determines the legal standards to be applied to the requested relief.

The court found that the PDVSA parties fundamentally asserted “that the Panel grossly misapplied well-established New York contract law regarding the enforceability of contract provisions operating as a penalty.”[238] The Panel agreed with ConocoPhillips’ that a contract clause can only be considered to be an unenforceable penalty if it is also a liquidated damages clause. Since the Panel determined that the Call Option was a termination provision rather than a liquidated damages provision, it could not be an unenforceable penalty. The court noted that “neither party has introduced any legal authority that conclusively answers the question put before the Panel concerning whether the Call Option acted as a penalty.”[239] However, applying the prescribed standard of review for the decision of the Panel, it concluded that the PDVSA parties failed to meet “their ‘burden of demonstrating the existence of a clearly governing legal principle and the arbitrator’s manifest disregard of such a principle.’”[240] The court denied the PDVSA parties’ motion to vacate.

Finally, the court addressed the cross-petition of ConocoPhillips seeking confirmation and enforcement of the award, which was governed by the

236. *Id.*
237. *Id.*
238. *Id.* at *8.
239. *Id.* at *9.
240. *Id.* (citing In re Arbitration Between Atherton & Online Video Network, Inc., 274 F.Supp.2d 592, 595 (S.D.N.Y. 2003)).

same two international conventions as the petition of the PDVSA parties. Applying the appropriate standard of review, the court found that,

> [t]he Panel's alleged misapplication of New York contract law concerning unenforceable penalties does not violate the state or nation's "most basic notions of morality of justice." . . . "[E]rroneous legal reasoning or misapplication of law is generally not a violation of public policy within the meaning of the [Inter-American] Convention."[241]

Finding that the PDVSA parties failed to meet their burden of demonstrating that summary affirmance was not appropriate, the court confirmed, recognized and enforced the Panel's Award.

C. Court finds that Shell's responses to inquiries from the U.S. Department of Justice regarding possible violations of the Foreign Corrupt Practices Act by one of Shell's contractors were absolutely privileged.

The Texas Court of Appeals' decision in *Writt v. Shell Oil Co.*,[242] was discussed in the 2013 edition of this annual report. The issue in this case was whether the defendants had "an 'absolute privilege,' or 'immunity,' to make [alleged] defamatory statements about [Writt] to the United States Department of Justice ('DOJ')."[243] In his employment with Shell, Writt

> was charged with the responsibility of approving payments to contractors on certain Shell projects in foreign countries, including Nigeria. During the course of his work, Writt learned that certain Shell contractors were under investigation "by various governmental agencies" for making and receiving illegal payments and one of Shell's vendors had pleaded guilty to violating the Foreign Corrupt Practices Act ("FCPA").[244]

Writt alleged that the defendants voluntarily submitted a report to the DOJ, in response to an informal inquiry, that

> falsely stated that he had been involved in illegal conduct in a Shell Nigerian project by recommending that Shell reimburse

241. *Id.* at *12.
242. 409 S.W.3d 59 (Tex. App. 2013), *rev'd* 464 S.W.3d 650 (Tex 2015).
243. *Id.* at 61.
244. *Id.* at 62.

> contractor payments he knew to be bribes and by failing to report illegal contractor conduct of which he was aware.[245]
>
> The trial court granted the defendants' motion for summary judgment and determined that the defendants had an absolute privilege and immunity with regard to the alleged defamatory statements at issue in this lawsuit. Writt appealed.

In a lengthy split decision of the three-judge panel, the majority of the Texas Court of Appeals panel reversed the trial court's decision and ruled that the statements of the defendants were not absolutely privileged, but were instead only conditionally privileged.[246]

In further appellate proceedings, the Texas Supreme Court reversed the judgment of the court of appeals, concluding that "Shell's statements were made preliminary to a proposed judicial proceeding and were absolutely privileged."[247] The court first noted that Texas law recognizes two classes of privileges applicable to defamation suits—absolute privilege and conditional or qualified privilege. While "[a]n absolute privilege is more properly thought of as an immunity,"[248] the conditional or qualified privilege "is lost if abused, such as when the statement is made with malice and with knowledge of its falsity."[249] Important to the facts at issue in this case, the court found that:

> The fact that a formal proceeding does not eventually occur will not cause a communication to lose its absolutely privileged status; however, it remains that the possibility of a proceeding must have been a serious consideration at the time the communication was made.[250]

The court also emphasized that Shell's actions occurred in an atmosphere of growing enforcement actions by the DOJ. FCPA enforcement actions more than doubled over the year preceding the DOJ's action in 2007 informing Shell of its investigation. FCPA enforcement actions more than

245. *Id.* at 63.

246. The court noted that "[t]he distinction between the absolute privilege and the conditional, or qualified, privilege is that 'an absolute privilege confers immunity regardless of motive whereas a conditional privilege may be lost if the actions of the defendant are motivated by malice.'" *Id.* at 66.

247. *Writt*, 464 S.W.3d at 651.

248. *Id.* at 654.

249. *Id.* at 655.

250. *Id.*

doubled again from 2007 through 2010 when the DOJ and Shell entered into a Deferred Prosecution Agreement.[251] Moreover, the court noted that both federal prosecutors and the U.S. Sentencing Guidelines "place a high premium on self-reporting, along with cooperation and remedial efforts, in determining the appropriate resolution of FCPA matter."[252] The court concluded:

> In sum, the summary judgment evidence is conclusive that when Shell provided its internal investigation report to the DOJ, Shell was a target of the DOJ's investigation and the information in the report related to the DOJ's inquiry. The evidence is also conclusive that when it provided the report, Shell acted with serious contemplation of the possibility that it might be prosecuted.[253]

Finding that the actions of Shell in providing its internal report to the DOJ was an absolutely privileged communication, the court reversed the judgment of the court of appeals and reinstated the judgment of the trial court in favor of Shell.

It bears noting that six former United States Attorneys General (Michael B. Mukasey, Benjamin R. Civiletti, Edwin Meese, III, Richard L. Thornburgh, William P. Barr and Alberto R. Gonzales) submitted an *amicus curiae* letter in support of Shell. The United States Chamber of Commerce, the National Association of Manufacturers and the American Petroleum Institute submitted an *amicus* brief in support of Shell.[254]

D. Series of lawsuits involving international companies and operations tested the limits of finding jurisdiction in the United States courts.

In *International Energy Ventures Management, L.L.C. v. United Energy Group, Limited*,[255] the plaintiff (IEVM) appealed the district court's dismissal of this lawsuit against the defendant UEG for lack of personal jurisdiction. The underlying facts in the case involved the announcement in July 2010 that "British Petroleum ('BP') . . . that it wished to sell its Pakistani subsidiaries that owned oil and gas fields in Pakistan."[256] IEVM made a presentation regarding BP's Pakistani assets to UEG, a Chinese oil

251. *Id.* at 659.
252. *Id.*
253. *Id.*
254. *Id.* at fn. 1.
255. 800 F.3d 143 (5th Cir. 2015).
256. *Id.* at 147.

and gas company located in Beijing. Under a compensation agreement agreed to by UEG and IEVM, "IEVM was to assist UEG in its technical evaluation and in sourcing financing and act as consultants on behalf of UEG for the acquisition of the BP Pakistan Assets."[257] IEVM later learned that BP had sold the Pakistan assets to UEG.

When UEG repeatedly declined to pay the compensation that IEVM contended was due it under the Compensation Agreement, IEVM sued UEG for breach of contract, promissory estoppel, quantum meruit and fraud. "[F]ollowing the removal of this case to federal court, UEG moved to dismiss for lack of personal jurisdiction."[258] The district court granted that motion. IEVM appealed.

In order to determine whether IEVM had shown that the court had specific jurisdiction over UEG, the court examine "the pre-litigation contacts that UEG purposefully established with the state of Texas:"[259]

> UEG sent a letter of interest, negotiated with, and sent a bid to BP's Houston office, the hub of the BP deal, in an attempt to secure the BP Pakistan Assets. UEG retained Mueller, a Texas resident, as one of its two principal contacts on the BP deal. UEG contracted with Texas-based IEVM to perform consulting work on the BP deal and sent payment to IEVM in Texas. UEG contracted with the Houston offices of Dewey & LeBoeuf (attorneys), Degolyer & McNaughton (consultants), and Ernst & Young (accountants) to advise it on the BP deal. UEG's Chief Financial Officer travelled to Houston to sign the deal and to attend a dinner celebration.[260]

The court concluded that IEVM met its prima facie burden of showing specific jurisdiction. The court reversed the district court's dismissal of UEG from the lawsuit because the court had personal jurisdiction over UEG.

In *Brenham Oil & Gas, Inc. v. TGS-NOPEC Geophysical Company*,[261] Brenham sued TGS and ENI, S.p.A. alleging that Brenham's efforts to reach an oil production agreement with the Republic of Togo failed due to the tortious interference of TGS. TGS was "a company that gathers and markets seismic data for the hydrocarbon industry. ENI, an Italian

257. *Id.*
258. *Id.*
259. *Id.* at 153.
260. *Id.*
261. 472 S.W.3d 744 (Tex. Civ. App 2015).

company, was accused of aiding and encouraging TGS's tortious conduct."[262] The trial granted ENI's special appearance and dismissed ENI from the lawsuit based on the lack of personal jurisdiction over ENI. Brenham appealed.

In a lengthy opinion that describes the facts in great detail, the Texas Court of Appeals summarized the facts alleged by Brenham to support general jurisdiction in Texas:

> Brenham Oil notes evidence of a trip by ENI executives to an industry conference in Houston where they met with representatives of several oil companies, as well as two trips by ENI's CEO to Texas for business meetings and speaking engagements. Brenham further observes that on 39 occasions between 2009 and 2012, other ENI employees visited Texas on business trips for the company, as evidenced by numerous letters of invitation from Texas subsidiary ENI U.S. Operating Co. to the American consulate in Milan. The stated purpose of these visits generally was to work with or advise ENTs Texas subsidiaries. Finally, Brenham points to evidence that ENI assumed an active role in negotiating a lease of Houston office space on behalf of ENI U.S. Operating Co. ENI employees traveled to Houston to survey the property and offer support in making the new offices match the "ENI standard."[263]

In pointing to the above activities of ENI on behalf of its subsidiaries as a basis for general jurisdiction, Brenham did not deny that the subsidiaries were separate corporate entities. The court concluded that ENI's contacts with Texas were not shown to be sufficiently continuous and systematic to render ENI essentially at home in Texas, and that Brenham failed to show that ENI is subject to general jurisdiction in Texas.[264]

The court also found that, because Brenham Oil's claims against ENI do not arise from the alleged forum contacts, the trial court did not err in dismissing Brenham's claims based on the additional finding of a lack of specific jurisdiction.[265]

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262. *Id.* at 750.
263. *Id.* at 759.
264. *Id.* at 763.
265. *Id.* at 765.

VIII. Other Energy Industry Cases

A. Court addresses attempt by party to use pretrial discovery procedures as a means of obtaining commercial data that was sought as part of the ultimate relief requested in the lawsuit.

In *Ring Energy, Inc. v. Hullum*,[266] the court was presented with a discovery dispute involving the Hullum defendants' attempt to use pretrial discovery procedures to obtain access to geophysical exploration data that was also sought by the defendants as part of the ultimate relief requested by them in the lawsuit. The plaintiff Ring Energy and the Hullum defendants had entered into a merger agreement under which the defendants agreed to assign certain oil and gas leases to Ring in exchange for cash and stock in Ring Energy. Ring subsequently brought suit alleging that the defendants failed to meet their obligation to assign the oil and gas leases. The defendants denied those allegations and asserted counterclaims for breach of contract, specific performance and other related claims. Part of the basis for the counterclaims was the assertion that the merger agreement required Ring to provide the defendants with seismic reports and other information related to the leases, and that the information had not been provided.

The defendants sought to obtain the seismic reports both through discovery directed to Ring and through a non-party subpoena duces tecum directed to "the professional geologist commissioned by Ring to obtain seismic data and create the seismic reports."[267] Ring opposed both attempts to obtain the geophysical testing information through discovery. In response, the defendants argued that the information was relevant to various claims and defenses that would be presented at the trial of the action, and that Ring would have an unfair advantage in various ways if it, alone, had access to the reports during the pendency of the lawsuit.

With regard to the argument of Ring that to allow the defendants to obtain copies of the geophysical information through discovery would essentially grant the defendants part of the ultimate relief sought through their specific performance counterclaim, the court observed that

> [i]t is difficult to find cases in which a party seeks, as part of the ultimate relief, the disclosure of information and then seeks that same information through discovery. Cases in which this situation has arisen include those lawsuits arising out of Freedom of Information Act (FOIA) requests. In this context, the United

266. No. 15-cv-00109-JHP-TLW, 2015 WL 4413366 (N.D. Okla. July 17, 2015).
267. *Id.* at *1.

> States Supreme Court has addressed whether discovery requests which, if answered, would provide all of the relief the requesting party could obtain if that party were to prevail on the merits are appropriate.[268]

The court noted that the Supreme Court has concluded, in the context of FOIA litigation, that such discovery requests should *not* be allowed.[269] However the court in the present lawsuit distinguished those decisions on the ground that providing the Hullum defendants with the seismic reports would not provide them with all of the relief they would obtain if successful in this suit on the claim for specific performance, provided that an appropriate protective order is entered. The court also concluded that the seismic reports were "necessary in order for defendants to establish a number of their claims."[270]

While the court found that Ring had shown "good cause for limiting the use of the seismic reports in order to prevent defendants from prevailing prematurely on much of their specific performance claim,"[271] it concluded that the seismic reports could be obtained through discovery subject to stated limitations. The court directed that the defendants could not use the reports for any purposes other than the lawsuit, and it prohibited the use of the reports to negotiate renewals or extensions of oil and gas leases. It noted that this limitation might prevent the defendants from mitigating their damages if they ultimately prevail in the lawsuit, leading to a potential increase in the monetary damages recovered from Ring in that instance. However, the court found that Ring had chosen to take that risk given its objections to the defendants being allowed to fully use the information during the pendency of the litigation.[272]

B. As a matter of first impression, the Tenth Circuit holds that, for purposes of diversity jurisdiction in the federal courts, the citizenship of a master limited partnership consists of unitholders' citizenship.

The case of *Grynberg v. Kinder Morgan Energy Partners, L.P.*,[273] involved a lawsuit in which the plaintiffs (Grynbergs) petitioned the federal

268. *Id.* at *7

269. *Id.* (citing Cheney v. U.S. Dist. Court for Dist. of Columbia, 542 U.S. 367, 388 (2004)). *See also*, Tax Analysts v. I.R.S., 410 F.3d 715, 722 (D.C.Cir. 2005) (quoting Military Audit Project v. Casey, 656 F.2d 724, 734 (D.C.Cir. 1981)).

270. *Ring Energy*, 2015 WL 4413366 at *8, note 7.

271. *Id.* at *8.

272. *Id.*

273. 805 F.3d 901 (10th Cir. 2015).

district court to vacate an arbitration award entered against them and in favor of Kinder Morgan Energy Partners, L.P. (KMEP) and Kinder Morgan CO2 Company, L.P. The Grynbergs sued in federal court on the basis of diversity jurisdiction. At the time the lawsuit was filed, the Grynbergs were Colorado citizens. KMEP was a Delaware master limited partnership. The district court dismissed the Grynbergs' lawsuit for lack of jurisdiction.

> It concluded that under *Carden v. Arkoma Associates*, 494 U.S. 185, 195, 110 S.Ct. 1015, 108 L.Ed.2d 157 (1990), KMEP's citizenship was the citizenship of all its unitholders, and because KMEP had at least one Colorado unitholder, its citizenship was not completely diverse from the Grynbergs'.[274]

The Grynbergs appealed.

As a matter of first impression, the Tenth Circuit affirmed the district court's dismissal of the lawsuit and held that the citizenship of a master limited partnership consists of its unitholders' citizenship.[275] The court reached this conclusion finding that (a) the long-standing rule for determining citizenship of unincorporated entities (*i.e.*, that citizenship is typically determined by the entity's members' citizenship) applies to master limited partnerships, (b) the narrow exception to that rule, which applies to corporations, does not apply here, and (c) the Grynbergs' policy arguments in favor of expanding the exception to master limited partnerships are better addressed to the Congress than the courts.[276]

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274. *Id.* at 903.
275. *Id.* at 905.
276. *Id.* at 906.